103

MISCELLANEOUS REVENUE ISSUES

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Miscellaneous Revenue Issues, Seria...

HEARINGS

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

JUNE 17, 22, 24; JULY 13, 1993; AND SEPTEMBER 8, 21, 23, 1993

PART 3 OF 3

SUBMISSIONS FOR THE RECORD

Serial 103–65

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Treasurer

June 18, 1993

The Honorable Charles Rangel
Committee on Ways and Means
Subcommittee on Select Revenue Measures
U.S. House of Representatives
Washington, D.C. 20515

Re: NARUC Supports Provisions of H.R. 846

Dear Chairman Rangel:

On behalf of the National Association of Regulatory Utility Commissioners (NARUC), I wish to indicate our support for legislation repealing the taxability of contributions in aid of construction (CIAC) to regulated water and wastewater utilities. These provisions are currently contained in H.R. 846, which was introduced by Representative Robert Matsui earlier this year.

I understand that your Subcommittee held a hearing on this legislation June 17th. The NARUC has requested that this legislation become part of the budget reconciliation legislation in the Senate. I also urge you to support its inclusion in the final budget bill that emerges from a conference committee.

Since 1987, the NARUC, which represents the State regulatory agencies responsible for the regulation of water utilities, has supported an amendment to the 1986 Internal Revenue Code that would exempt CIAC from the taxable income of public utilities. The NARUC continues to support repealing the CIAC tax because we believe it will result in a more equitable assessment of Federal taxes on regulated water and wastewater utilities and their ratepayers. Copies of our resolutions supporting repeal of the CIAC tax are attached.

H.R. 846 contains a provision disallowing accelerated depreciation for water utility property placed in service after enactment. This provision, which the NARUC also supports, would allow this legislation to actually generate more revenue than it would lose.

NARUC NUCLEAR WASTE PROGRAM
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I want to thank you for allowing me to present the NARUC's views on this critically important issue to all State utility commissioners. Should you or your staff have any questions regarding our position you may contact me directly at the New Hampshire Public Utilities Commission (603-271-2290) or Mr. Thomas Choman, NARUC Director of Congressional Relations (202-898-2206).

Sincerely yours,

Linda Bisson Stevens

Linda Bisson Stevens
Commissioner
Chair, NARUC Committee on Water

cc: The Honorable Dan Rostenkowski, Chairman, Ways and Means Committee
The Honorable Robert Matsui, Member, Ways and Means Committee

Attachments

Resolution Regarding Contributions in Aid of Construction Water and Sewer Utilities

WHEREAS, Contributions in Aid of Construction (CIAC) finances substantial amounts of the capital costs for water and sewer utilities; and

WHEREAS, State regulatory commissions do not allow CIAC to be included in the investment base upon which a utility is allowed the opportunity to earn a return; and

WHEREAS, Regulatory commissions authorize the collection of CIAC to reduce the utility's investment which serves to reduce monthly rates to customers; and

WHEREAS, A utility has not been allowed to depreciate CIAC property on its tax return; and

WHEREAS, The Tax Reform Act of 1986 treats these CIAC funds as income to the utilities; and

WHEREAS, Water and sewer utilities are severely impacted because of the large amounts of CIAC funds they receive; and

WHEREAS, The result of the Tax Reform Act of 1986 will be to substantially increase the cost of providing water and sewer utility service to the public; now, therefore be it

RESOLVED, That the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC), assembled in its Winter Committee Meeting in Washington, D.C., supports the exemption of CIAC funds received by water and sewer utility companies from income tax liability; and be it further

RESOLVED, That the Executive Committee encourages and supports an amendment to the Tax Reform Act of 1986 which would exempt contributions in aid of construction from income tax for water and sewer utilities.

Sponsored by the Committee on Water
Adopted February 25, 1987

Resolution Regarding Contributions in Aid of Construction for Regulated Public Utilities

WHEREAS, Contributions in Aid of Construction (CIAC) finance substantial amounts of the capital costs for public utilities; and

WHEREAS, State regulatory commissions do not allow CIAC to be included in the investment base upon which utility is allowed the opportunity to earn a return; and

WHEREAS, Regulatory commissions authorize the collection of CIAC to reduce the utility's investment which serves to reduce monthly rates to customers; and

WHEREAS, A utility has not been allowed to depreciate CIAC property on its tax return; and

WHEREAS, The Tax Reform Act of 1986 treats CIAC funds as income to the utilities; and

WHEREAS, Public utilities, especially water and sewer utilities, are severely impacted by the increased taxes because of the large amounts of CIAC funds they receive; and

WHEREAS, The result of the Tax Reform Act of 1986 was to unfairly increase the cost of providing utility service to the public; and

WHEREAS, On February 25, 1987, the Executive Committee of the National Association of Regulatory Utility Commissioners (NARUC) adopted a "Resolution Regarding Contributions in Aid of Construction for Water and Sewer Utilities" at its Winter Meeting in Washington, D.C., encouraging and supporting an amendment to the Tax Reform Act of 1986 which would exempt contributions in aid of construction from income taxes for water and sewer utilities; and

WHEREAS, The NARUC joined in a Legislative Coalition of organizations supporting exemption of CIAC from income taxes for all public utilities; and

WHEREAS, No action has yet been taken by Congress to amend the Tax Reform Act of 1986 to exempt CIAC from income taxes; and

WHEREAS, House of Representatives Bill 118 and identical Senate Bill 1398 have been introduced in the 102nd Congress to exempt from taxation under the Internal Revenue Code of 1986 contributions in aid of construction made to regulated public utilities; now, therefore, be it

RESOLVED, That the Executive Committee of the NARUC, convened at its Summer Meeting in San Francisco, supports the exemption of CIAC funds received by regulated public utility companies from income tax liability; and be it further

RESOLVED, That the NARUC Executive Committee encourages and supports an amendment to the Internal Revenue Code of 1986 which would exempt contributions in aid of construction from income tax for regulated public utilities.

Sponsored by the Committee on Water
Adopted July 24, 1991
Reported NARUC Bulletin No. 31-1991, pages 22-23

Associated Bank

June 28, 1993

Ms. Janice Mays
Chief Counsel & Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Statement for Inclusion in the Written Record of the Printed Ways and Means Select Revenue Measures Sub Committee Hearings

Dear Chief Counsel Mays:

Associated Bank, N.A. supports the adoption of the provision which would permit the tax-free conversion of common trust funds to one or more proprietary or non-proprietary mutual funds. We believe this provision will provide a significant step toward enhancing the stability and economic health of the banking industry, resulting in benefits to our customers and the nation as a whole.

The measure will also benefit consumers by providing them with the choice of a savings vehicle that can generate a more reasonable rate of return on dollars invested than is generally available to them at banks in the current environment. Recent surveys have indicated that upwards of 80% of households prefer to look to their local bank for financial advice and for investment products. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Therefore, they are looking elsewhere. Bank-provided mutual funds would provide a very attractive investment vehicle for these individuals.

Among the key benefits of mutual funds from the Government's perspective is that they are highly regulated (both under the Investment Company Act of 1940 and the Internal Revenue Code). Mutual funds provide an investment alternative for stimulating savings while providing a more reasonable rate of return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition, there is no shareholder tax deferral inherent in the vehicle, due to tax requirements to distribute virtually all of the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, highly-regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus, supporting the economic health of their local economies, the banking industry, and the nation's economic recovery process.

Respectfully submitted,
ASSOCIATED BANK, N.A.

Michael B. Mahlik
Executive Vice President
& Managing Trust Officer

MBM/jh

STATEMENT OF THE BANK SECURITIES ASSOCIATION

The Bank Securities Association appreciates the opportunity to present to the Subcommittee on Select Revenue Measures ("Subcommittee") of the House Ways and Means Committee its views concerning the proposal before the Subcommittee which would permit the tax-free conversion of a bank common trust fund into one or more mutual funds. The Bank Securities Association strongly supports the objectives of this proposal, which, as discussed more fully below, provides appropriate and much needed clarification regarding the tax treatment for converting bank common trust funds into mutual funds.

The Bank Securities Association is the nation's leading membership based not-for-profit trade association exclusively dedicated to representing the offering of securities and other investment services and products by banks and other financial institutions. Our membership includes commercial banks, thrift institutions, securities firms, investment companies, and other organizations in the financial services industry. We provide a wide range of services to members including educational conferences, seminars, bi-monthly magazine, newsletter, legislative/regulatory support, and numerous directories and other publications.

BACKGROUND AND CURRENT TAX LAW

A common trust fund is a fund maintained by a bank for the collective investment and reinvestment of accounts held by the bank in its capacity as trustee, executor, administrator, guardian or custodian for customers of the bank. Such funds are used exclusively to assist banks in administering their fiduciary accounts and generally may not be used as an investment vehicle for the general public. There are approximately 4,000 bank common trust funds throughout the country which, according to the Federal Financial Institutions Examination Council, hold assets totalling approximately $570 billion.

Common trust funds were developed by banks as a means to provide administrative efficiencies and other benefits to fiduciary account holders which simply could not be achieved by administering and investing each account separately. For example, the collective rather than separate investment of fiduciary accounts enables each account holder to achieve a level of investment diversification which would not be feasible if each account were invested separately. In addition, by pooling fiduciary account assets and managing those assets on a collective basis, banks are able to more efficiently administer those accounts, thereby reducing administrative expenses and achieving cost savings for fiduciary customers.

Historically, the benefits generated by collective investment of fiduciary accounts through common trust funds have been adequate to achieve the objectives, and meet the expectations, of bank fiduciary customers. However, in recent years, other bank-organized collective investment vehicles have evolved which provide even greater efficiencies and investment opportunities for bank customers, including fiduciary accounts. Most notably, throughout the past several years, banks have begun advising a wide array of mutual funds which offer a variety of investment choices and opportunities unprecedented in the banking industry, and which cannot be replicated by common trust funds, given current legal limitations applicable to such funds.

In view of the substantial benefits which can be provided to fiduciary customers through mutual funds, banks and their common trust fund customers increasingly are seeking to "convert" common trust fund assets into mutual funds. However, uncertainty regarding the federal tax treatment of such a transaction has created a significant impediment to the conversion of many common trust funds into mutual funds. More specifically, although the Internal Revenue Service generally permits the merger or consolidation of two or more common trust funds on a tax-free basis, current law is much less clear as to whether conversion of a common trust fund into one or more mutual funds results in a taxable event. Without unambiguous tax guidance in this area, the conversion of many common trust funds into mutual funds often is too uncertain to pursue. In this regard, the relationship between a bank and its common trust fund customers is by definition a fiduciary relationship which, under the laws of many states, could be found to have been breached if the trust account incurs unnecessary income tax liability. Consequently, banks could face significant potential liabilities and costly litigation in the event the conversion of a common trust fund into a mutual fund results in adverse tax consequences to the common trust fund customers. This risk alone has prevented the conversion of most common trust funds into mutual funds, notwithstanding the considerable potential benefits to customers of doing so.

THE PROPOSAL

The proposal before the Subcommittee would eliminate the uncertainty under existing law, by permitting a common trust fund to transfer substantially all of its assets to one or more mutual funds without gain or loss being recognized by the fund or its participants. Under the proposal, the fund must transfer assets to the mutual fund or funds solely in exchange for mutual fund shares. The trust fund would be required to distribute the mutual fund shares to the trust fund participants in exchange for the participants' interests in the trust fund. In addition, the proposal would require that each participant's pro-rata interest in each mutual fund must be substantially the same as was the participant's pro-rata interest in the trust fund and that the resulting mutual fund meet certain diversification requirements. The proposal is similar to provisions that Congress passed in the two tax bills that President Bush vetoed in 1992 and are contained in section 623 of H.R. 13, the Tax Simplification Act of 1993. In effect, the proposal would confirm the tax-free nature of this essentially non-substantive form of reorganization.

The proposal would protect common trust fund customers from incurring tax liability until the customer actually withdraws the investment. In this regard, it is important to note, however, that the proposal would not result in a decrease in tax revenues derived from participants in a common trust fund which is converted into one or more mutual funds. Each participant would be required to recognize any gain derived when the mutual fund investment is sold. This would result in the identical tax treatment applying as if the common trust fund were never converted into a mutual fund and the fund participant withdrew from the fund.

By clarifying the tax-free treatment of converting common trust funds to one or more mutual funds, the proposal would provide significant benefits to common trust fund participants, as well as to banks managing those funds. For example, mutual funds are able to pool the assets of a wide variety of investors as compared to common trust funds which, as noted above, are comprised only of assets held by a bank in its capacity as fiduciary for customers of the bank. As a result, mutual funds provide potential for a larger asset base than typically is possible with a common trust fund. A larger asset base can result in economies of scale which produce greater operating efficiencies and lower costs to all participants in the fund. It also provides opportunities for increased investment diversification.

Moreover, by facilitating the conversion of common trust funds to mutual funds, the proposal would provide other benefits to fiduciary customers of banks. For example, such customers would find it easier to monitor their investments by accessing publicly available market quotes published on a daily basis for mutual funds in newspapers, as contrasted with valuation reports for common trust funds which generally are made available to fund participants no more than monthly. Participants in common trust funds which are converted to mutual funds also would enjoy increased liquidity. In this connection, mutual funds typically allow investment in, and withdrawal from, the fund on a daily basis rather than on a monthly basis as is usual for common trust funds.

The proposal also would provide significant benefits to banks that currently manage common trust funds. In particular, by clarifying that banks may convert common trust funds into mutual funds on a tax-free basis, the proposal would enable banks to offer more competitive services to their customers. This not only would improve the ability of those banks to keep existing customers, but it also would enhance their ability to compete with other investment management providers for new customers. Moreover, the proposal would facilitate the formation of proprietary mutual funds by many banks that, because of a limited existing customer base or other similar constraints, otherwise would be unable to obtain the level of assets necessary for the success of a proprietary mutual fund. In doing so, the proposal would not only enhance the ability of such banks to serve their existing trust customers, but also would significantly increase their ability to provide competitive investment management services to other customers of the bank. In sum, consumers would be the ultimate beneficiaries if the proposal were enacted.

CONCLUSION

The Bank Securities Association strongly supports the proposal being considered by the members of the Subcommittee to clarify that a common trust fund may be converted into one or more mutual funds on a tax-free basis. The proposal would enable existing participants in common trust funds to obtain access to the benefits offered by mutual funds, and would enhance the ability of banks to provide more competitive services to their fiduciary and other customers, and to compete with other investment management providers. The proposal accomplishes these important objectives without decreasing tax revenues derived from participants in common trust funds. We urge the members of the Subcommittee to support the proposal.

Bank South

June 22, 1993

J. Blake Young, Jr.
Executive Vice President
Investment Management
and Trust Services

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

KPMG Peat Marwick supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advise. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in this vehicle, due to tax requirements to distribute virtually all of the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus supporting the economic health of the entire banking industry and the nation's economic recovery process.

Respectfully submitted,

J. Blake Young, Jr.
Executive Vice President

cc: Dan Rostenkowski, Chairman, House Ways and Means Committee
Charles Rangel, Chairman, Select Revenue Measures Subcommittee
John L. Lewis, 5th Georgia District

Bank South, N.A., P.O. Box 4387, Atlanta, Georgia 30302/(404) 529-4111

Barnett Bank

Barnett Banks Trust Company, N.A.

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Building 100
Post Office Box 40200
Jacksonville, Florida 32203-0200
904/464-2010

Michael C. Baker
President and Chief Executive Officer

June 21, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C.

RE: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

Barnett Banks Trust Company, N.A., supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection, is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulations of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition, there is no shareholder tax deferral in the vehicle, due to tax requirements to distribute virtually all the income to the shareholders on any annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus, supporting the economic health or the entire banking industry and the nation's economic recovery process.

Respectfully submitted,

Michael C. Baker

cc: Chairman Dan Rostenkowski, House Ways and Means Committee
Chairman Charles Rangel, Select Revenue Measures Subcommittee
Representatives Sam Gibbons, E. Clay Shaw and Bill Archer

Commerce Bancshares, Inc.

1000 Walnut Street
P.O. Box 13686
Kansas City, MO 64199-3686
(816) 234-2000

June 24, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: Statement for inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

Commerce Bank supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, and therefore, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings and investment vehicle that can generate a more reasonable return than is generally currently available to them at banks. The mutual fund as an investment alternative provides a highly regulated opportunity (under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving, while providing a more reasonable return than current traditional bank products. The stringent regulation of mutual funds, coupled with the required strict diversification of the assets of mutual funds provides a considerable level of safety for bank customers.

A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Moreover, the provision will enable banks to maintain their customer base, improving not only the health of the banking industry, but the nation's economic recovery as well.

Respectfully submitted,

John S. Archer
John S. Archer
Senior Vice President

cc: Dan Rostenkowski, Chairman, House Ways and Means Committee
Mel Hancock, Member, Select Revenue Measures Subcommittee

FIRST
FIDELITY

First Fidelity Bank, N.A., New Jersey
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C76501
201 430-4309
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John J. Phillips
Senior Vice President

June 22, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Statement for inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

First Fidelity Bank NA, New Jersey supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers.

Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in the vehicle, due to tax requirement to distribute virtually all the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Respectfully submitted
First Fidelity Bank, N.A. NJ

cc: Dan Rostenkowski, Chairman, House Ways and Means Committee
Charles Rangel, Chairman, Select Revenue Measures Subcommittee

TESTIMONY OF MICHAEL P. TRABA

on behalf of

THE FIRST NATIONAL BANK OF CHICAGO

Chairman Rangel, and Members of the Subcommittee, my name is Michael P. Traba, a Vice President of The First National Bank of Chicago, headquartered in Chicago, Illinois. I am submitting testimony, as a representative of First Chicago, to the Subcommittee in support of the proposal to permit bank common trust funds to transfer its assets to mutual funds on a tax-free basis.

The First National Bank of Chicago is a commercial bank offering a wide range of banking and investment services to customers throughout the United States and around the world. As of March 31, 1993, the Bank was one of the largest commercial banks in the United States in terms of assets ($ 48.4 billion) and in terms of deposits ($ 27.6 billion). At the end of the first quarter of 1993, the Bank was providing investment management services to portfolios containing approximately $ 9.1 billion in assets.

BACKGROUND

Banks often act as Trustees or Co-Trustees for billions of dollars worth of trust assets. The primary investment vehicle for many of these assets are common trust funds. The common trust funds are created and operated pursuant to regulations promulgated by the Office of the Comptroller of the Currency ("OCC"). Each of the common trust funds are administered under its own separate and distinct investment parameters.

As trustee for each individual client or trust, the Bank makes an investment allocation decision, selects the type of investments appropriate for that trust, and decides the percentages of that trust's assets to be allocated to each separate investment class. Having made this investment decision, the Bank then invests the trust assets in individual securities or one or more of the common trust funds, as appropriate.

In its role as trustee for each common trust fund, the Bank provides the investment management of the commingled assets. It also administers the common trust fund, provides custody for its assets, does all of the record keeping, and provides the needed tax and other information to the individual participating trusts. The common trust funds themselves are not taxable entities. All income is distributed to participating trusts without changing the character of the income. The individual trusts are also charged with any short or long term capital gains and losses from sales within the common trust fund regardless if any income is distributed. However, mutual funds, unlike common trust funds, alter the nature of the income distributed. Short term capital gains, for example, are distributed as ordinary income. As a result, this income is limited to the extent it could be offset by capital losses. Short term capital gains from a common trust fund are

Mutual funds also do not distribute capital losses, but rather retain them to offset future capital gains, if any. Consequently, mutual fund shareholders, are not afforded the ability to use these losses to offset ordinary income, as are unit holders of a common trust fund. Although, the current tax treatment accorded withdrawals or sales is the same for both common trust funds and mutual funds. Other IRS provisions have the effect of "speeding" up the tax on capital gains from mutual funds compared to common trust funds.

Moreover, customers who are currently invested in common trust funds should not realize any gain from the conversion from one collective investment vehicle to another. The conversion of a common trust fund to a mutual fund should be treated like any other tax free like-kind exchange. Such a conversion is akin to a merger between two existing mutual funds which allows securities to move intact from one fund to another with no tax consequences. Likewise, under current law, two or more common trust funds may merge without any tax consequences.

The Internal Revenue Code treatment of bank customers in a conversion from a common trust fund to a mutual fund is ambiguous. The IRS has indicated that it is reluctant to rule on the matter because the issue is "under review" by Congress. As a consequence, a legislative clarification is needed. In 1991, the previous Administration proposed, as part of its banking reform package, that common trust funds should be allowed to convert to mutual funds without triggering a taxable event.

DISCUSSION

Banks need to be able to compete effectively and efficiently with nonbanking financial service providers. Banks already manage large amounts of customer investments through common trust funds because, historically, this was the best collective investment vehicle that banks could offer.

However, now mutual funds are a superior collective investment vehicles for a number of reasons, and provide numerous benefits which bank customers invested in common trust funds do not enjoy. Mutual funds have daily pricing of their net asset value and daily liquidity, common trust funds do not. Mutual funds are quoted by the National Association of Securities Dealers Market Quotation System, and as a result, investors can see the prices of their mutual funds quoted in newspapers and other financial publications. Current regulations of the OCC prohibit "advertising" of common trust fund prices, yields and performance. If the clarification is enacted, investors could obtain critical financial information more readily. Likewise, OCC regulations prohibit the ability for units of a common trust fund to be pledged as security for a loan. Because a common trust fund must remain in a trust account, it is more difficult to give units of a common trust fund as a gift compared to a mutual fund. It is only the threat of incurring a "tax penalty" for their customers which prohibits many banks from making this superior investment product available to their trust customers.

The First National Bank of Chicago would like to be able to convert its common trust funds to mutual funds in order to provide a greatly expanded range of investment choices for both its trust and non-trust customers. In a conversion, the assets of a bank common trust fund are transferred to a mutual fund with similar investment objectives, to which the bank may serve as an investment advisor, performing in much the same manner as it had for the common trust fund. In the past, the conversion has been hindered because it was unclear if bank trust customers would have to pay a tax on any gains in the trust account at the time of the conversion.

First Chicago has supported this legislative proposal for some time. The Bank has indicated its strong support for this legislation during prior consideration of the issue. In fact, Congress has twice passed legislation to permit a common trust fund to be converted to a mutual fund without triggering adverse tax consequences. When these legislative proposals were not enacted into law last year, Chairman Rostenkowski introduced a bill, H.R. 13, which contained a specific section allowing this type of transaction to proceed without unfortunate tax consequences.

This legislation was recommended by the Treasury Department in 1991 as part of its overall proposals to modernize the banking industry and, at least thus far, has not encountered any opposition. Each time the legislation has been considered, the failure to gain enactment had nothing to do with the provisions relating to conversion of common trust funds to mutual funds.

Larger institutions, such as The First National Bank of Chicago, have a broad and diverse customer base and to accommodate our clients we are the investment advisor to the First Prairie Family of mutual funds. Our customers rely on our bank for sound investment advice and management. These funds are one way we meet those needs. In addition to this investment management and dedication to quality service, our customers have the benefit of daily market quotes and the ability to alter their portfolios to more closely match specific investment goals.

An important point should be made, however, that this legislation does not affect the existing banking and investment laws relating to a bank's role in dealing with mutual funds. Under current law, banks are permitted to be an investment advisor to a proprietary mutual fund, but they may not be the sponsor, distributor, or underwriter of the fund due to the restrictions of the Glass-Steagall Act.

The current regulatory protections concerning trust beneficiaries would be enhanced. Mutual funds established in the wake of this legislation would have the additional benefit of being regulated by the Securities and Exchange Commission. These regulations are designed to protect and inform the consumer. Common trust funds are not subject to these safeguards. Members of the securities industry and the Investment Company Institute would still be needed to sponsor and distribute the funds as this legislation would not effect the Glass-Steagall Act.

The Comptroller of the Currency would continue its authority over national banks, including their fiduciary activities regarding trust customers and as investment advisor to mutual funds. It is important to note that the conversion would not diminish any of the fiduciary duties which the banks currently have towards investments in the trusts which today participate in common trust funds.

CONCLUSION

Clarifying that the conversion from common trust funds to mutual funds would not trigger a taxable event would be tremendously important in both encouraging savings and enhancing the competitiveness of the banking industry. The proposal, if made prospective, would not reduce tax revenues and could potentially add incremental revenues to the U.S. Treasury. Revenues considerations aside, the benefits to our clients and the investing public at large far out weigh the costs of this proposal.

1st Source Bank®

P. O. Box 1602
South Bend, Indiana 46634
219/235-2000

June 22, 1993

FEDERAL EXPRESS
Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Statement for Inclusion in the Written Record
of the Printed Ways and Means Select
Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

1st Source Bank supports the adoption of Section 623 of H.R. 13 to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide for a more economically stable banking industry.

This measure will benefit our customers by providing them an alternative investment vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them through bank certificates of deposit. Also, bank-provided mutual funds would allow us to remain competitive with brokerage firms and insurance industry.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of our customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition, there is no shareholder tax deferral inherent in the vehicle due to tax requirements to distribute virtually all the income to the shareholders on an annual basis.

Adopting this provision would allow us to offer our customers a wider range of acceptable, regulated investment choices. Furthermore, the provision will enable us to maintain our customer base; thus, supporting the economic health of our industry and the nation's economic recovery process.

Respectfully submitted,

James P. Coleman
Senior Vice President

First Trust

P.O. Box 64704
Saint Paul, Minnesota 55164-0704
612 291-5243
612 973-0182 (Mpls)

John M. Murphy, Jr.
Chairman

June 24, 1993

AIRBORNE EXPRESS
Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

First Trust National Association supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in the vehicle, due to tax requirements to distribute virtually all the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Respectfully submitted,

John M. Murphy Jr.

John M. Murphy
Chairman

JMM:gjp
cc: Dan Rostenkowski, Chairman
House Ways and Means Committee
Charles Rangel, Chairman
Select Revenue Measures Subcommittee

Hawaiian Trust Company, Ltd.

June 24, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Dear Ms. Mays:

RE: H. R. 13, SEC. 623: TAX-FREE CONVERSION OF BANK COMMON TRUST FUNDS TO MUTUAL FUNDS

You have undoubtedly received many communications from banking organizations about the importance to the banking industry of restoring to the current tax bill the provision that was in last year's bill, to permit tax-free conversion of bank common trust funds to mutual funds. I will not bore you by repeating the arguments you have heard again and again. I would like to emphasize one thought: The Treasury will not realize additional capital gains tax revenues if the tax-free conversion provisions are not added back to H. R. 13. Banks will simply not convert their common trust funds to mutual funds if tax-free conversion is not permitted, and, therefore, there will be no gains to tax.

For a bank to subject its trust clients to unnecessary recognition of capital gains in moving them from common trust funds to mutual funds would be a serious violation of its fiduciary duty and a breach of trust for which it could be held liable.

So, without the tax-free conversion provisions, banks will not cause the gain to be recognized, Treasury will not reap additional new tax revenues, and banks will continue to be at a disadvantage in competing in the financial services marketplace.

A Trust and Investment Subsidiary of
Bank of Hawaii

I hope that you will take this into account as you consider amendments to H. R. 13.

Thank you for considering our views.

Sincerely,

DP:gs

cc: The Honorable Dan Rostenkowski
Chairman, Committee on Ways and Means
United States House of Representatives

The Honorable Patsy Mink
United States House of Representatives

The Honorable Neil Abercrombie
United States House of Representatives

TESTIMONY OF JAMES R. LAUFFER
PRESIDENT OF THE INDEPENDENT BANKERS ASSOCIATION OF AMERICA

ON CONVERSION OF BANK COMMON TRUST FUNDS

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS
JUNE 17, 1993

Mr. Chairman, Members of the Subcommittee: The Independent Bankers Association of America (IBAA) appreciates the opportunity to present its views on the question of whether to permit tax-free conversion of bank common trust funds into one or more mutual funds, as outlined in the Subcommittee's press release of June 2, 1993. IBAA is composed of approximately 6,000 of the nation's 11,300 commercial banks. Many of our members are located in smaller cities, towns, and rural areas across the country. My name is James Lauffer, and I serve as President of the Association, and also as President of the First National Bank of Herminie, an institution with assets of about $180 million, operating in three townships of Westmoreland County, Pennsylvania, having a combined population of less than 100,000.

Conversion proposals

The initial proposal on conversion of common trust funds into a single mutual fund was contained in the 1992 tax bill, and was carried over into section 623 of H.R. 13, introduced earlier this year. Background on the provision is set forth in the "Technical Explanation of the Tax Simplification Act of 1993 (H.R. 13)" [Joint Tax Committee Print 1-93, January 8, 1993, page 186]. Members of the Ways and Means Committee, and others, have since suggested that the original proposal be broadened to allow the tax-free conversion where such assets are received by two or more mutual funds (Press Release #4, page 2, Financial Institutions, item 2).

IBAA position

Our banks thank the Subcommittee for considering whether conversion should be permitted to more than one fund. We favor allowing two of more funds to participate in such conversions, because this would open this process to smaller and community banks, for reasons we will explain.

Industry profile

A recent letter printed in The American Banker stated that 3,043 U.S. banks possess trust powers, and about 80 common trust funds of these banks contain $75 million or more in assets ("Customers Win In Conversion Plan," American Banker, March 19, 1993). The $75 million figure is significant, because of industry estimates that $50 million to $100 million in assets is needed to establish a self-sustaining, profitable mutual fund.

According to the Federal Financial Institutions Examination Council (FFIEC). bank collective and common trust funds assets reached $520 billion at the end of 1991 (approximately $125 billion of this total was in personal trust funds).

The tendency for these trust funds to be concentrated in larger institutions is illustrated by other testimony the Subcommittee is scheduled to receive today from the Community Bankers Association of Illinois, noting that there are 175 common trust funds in that state and that only the five largest Illinois banks have such trust funds with more than $100 million in assets.

Advantages of conversions

Allowing tax free conversions of common trust fund assets would be advantageous to trust participants and other bank customers, because a greater range of financial products would be available to serve their purposes, and these new vehicles could be utilized without financial penalty. For banks, such mutual funds on site would be an inducement for both trust participants and other customers to maintain their money with bank-related products and services. In addition, banks that set up their own "private label," or proprietary, mutual funds could presumably earn additional fees as transfer agents and custodians for the funds.

Options for larger banks

Many large banks may already have sufficient assets in their common trust funds to establish a single diversified proprietary mutual fund at a level that should be profitable from the outset.

Options for smaller banks

Smaller banks, in contrast, do not ordinarily administer common trust funds in the $50 million to $100 million category. These banks thus do not have the "critical mass" to set up their own proprietary mutual funds. As a practical matter, smaller banks would seek to contract with commercial mutual funds for these services. Although these existing funds already have their financial infrastructures, the smaller bank would gain by being able to offer comparable mutual fund services to their customers. Many of these commercial providers offer more than one type of fund, or a family of funds, which we view as helpful to achieving the diverse (and often legally mandated) objectives of trust fund/mutual funds customers.

Reasons for IBAA position

Small community banks are interested in offering the same mutual fund-related services as their larger colleagues on similar terms, for competitive purposes, certainly, but also because we feel a responsibility in servicing customers in smaller communities where there may be no other financial institutions. Our association has, in fact, devoted considerable effort over the past year to designing a program that will enable the smallest community banks to offer mutual funds to their customers.

For beneficiaries, participants in common trust funds of both large and small banks are in the same position with respect to transferring their investments to mutual funds. It would thus seem fair to treat the beneficiaries comparably, regardless of the size of the bank holding the funds. For banking institutions, fairness means, as a practical matter, that community banks should be able to convert common trust funds into two or more existing commercial mutual funds.

Trust assets contained in common trust funds are there because individual trusts were established for specified purposes, such as administration of estates, protecting the assets of minor children, accumulation of funds for higher education, supporting aging relatives or benefiting charities. It seems to IBAA that allowing two or more mutual funds to participate in the conversion process would make sense in terms of accommodating, subject to legal and regulatory constraints, the diverse purposes for which the trusts making up the common trust funds were created.

Evolution of proposals

The IBAA would be pleased to work with the Subcommittee to address any concerns that arise in connection with our proposal, and otherwise perfect and advance such a provision in the interest of all concerned.

KPMG Peat Marwick

Financial Services Practice

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June 18, 1993

FEDERAL EXPRESS
Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for Inclusion in the written record
of the printed Ways and Means Select
Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

KPMG Peat Marwick supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in the vehicle, due to tax requirements to distribute virtually all the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Respectfully submitted,

KPMG Peat Marwick

Kathy Anderson

Kathy L. Anderson
Partner

cc: Dan Rostenkowski, Chairman, House Ways and Means Committee
Charles Rangel, Chairman, Select Revenue Measures Subcommittee

MAGNA
TRUST
Magna Trust Company

An Affiliate of MAGNA GROUP, INC.
222 East Main Street
Belleville, Illinois 62220-1604
618 233-2120

June 22, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Statement for Inclusion in the written record
of the printed Ways and Means Select
Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

Magna Trust Company supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in the vehicle, due to tax requirements to distribute virtually all the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provisions will enable banks to maintain their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Respectfully submitted,

Magna Trust company

Peter C. Merzian

Peter C. Merzian
Investment Officer

PCM/pms

cc: Dan Rostenkowski, Chairman, House Ways and Means Committee
Charles Rangel, Chairman, Select Revenue Measures Subcommittee

Meridian Asset Management, Inc.
P O Box 2000
Valley Forge, PA 19482

Meridian

Robert C. Williams
President and
Chief Executive Officer

June 25, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for Inclusion in the Written Record of the the Printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

Meridian Asset Management, Inc., and its affiliated asset management companies are pleased to support the proposal to permit tax-free conversion of bank common trust funds to one or more proprietary or nonproprietary mutual funds (hereafter "tax-free conversion").

Approval of the proposal for tax-free conversion is a very important action which will give banks and other corporate fiduciaries an opportunity to provide the critical mass of funds necessary to create and enhance proprietary and nonproprietary mutual funds and the increased total returns to depositors, clients and beneficiaries typically afforded by these mutual funds when compared with the more conventional time deposits.

Bank depositors will benefit from purchases of mutual funds through the increased total returns and diversification available to them in the funds.

Banks may benefit from the use of proprietary and nonproprietary mutual funds since use of these funds by bank depositors can provide fee income to banks to replace interest income lost on deposits used to purchase the funds. In addition, charges to banks on FDIC insurance required to insure deposits used to purchase mutual funds will be eliminated entirely, further enhancing bank profit margins.

The Government will benefit from a more sound and stable banking industry and a reduction in the number of claims presented to the FDIC on behalf of the depositors in some of these banks.

The proposed tax-free conversion will contribute to the economic health of our banking industry, further the process of economic recovery and benefit all of our citizens.

Sincerely,

Robert C. Williams

RCW/ejm

Midlantic National Bank
Metro Park Plaza
P.O. Box 600
Edison, NJ 08818
(908) 321-8390

MIDLANTIC

A.J. DiMatties
Director
Trust Investments

June 23, 1993

Janice Mays, Esq.
Chief Counsel and Staff Director
Committee of Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Re: **Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Sub-Committee Hearings**

Dear Chief Counsel Mays:

Midlantic National Bank strongly supports the adoption of the provision to allow the tax-free conversion of Common Trust Funds to one or more proprietary or non-proprietary Mutual Funds. We believe there are substantial similarities between Common Trust Funds and Mutual Funds. Both provide investors and particularly small investors the ability to participate in a professionally managed diversified pool of investments. This similarity would justify the ability to convert from a Common Trust Fund to a Mutual Fund without adverse tax consequences to these investors.

If there are dissimilarities in the investment vehicles, they stem from the more stringent regulation of the Mutual Fund. The Mutual Fund is subject to stricter diversification standards. The Mutual Fund is subject to stricter disclosure rules. The investor in the Mutual Fund can transfer in and out of the fund on a daily basis. The Common Trust Fund investor must often wait until month's end to join or to withdraw. The Mutual Fund affords more protection to the investor. These dissimilarities speak in favor of the Mutual Fund and against a policy which provides obstacles to the ability to move from a Common Trust Fund to a Mutual Fund.

By adopting the provision allowing banks the tax-free conversion of Common Trust Funds to Mutual Funds, bank customers will have a wider range of professional, well regulated investment vehicles from which to choose.

In addition, the provision will allow banks to maintain their customer base in a financial service environment which is extremely competitive due to the impact of the major providers of Mutual Funds.

Respectfully submitted,

A.J. DiMatties
Director
Trust Investments
Midlantic National Bank

AJD:amm

cc: Dan Rostenkowski, Chairman
House Ways and Means Committee

Charles Rangel, Chairman
Select Revenue Measures Committee

THE NORTHERN TRUST COMPANY

FIFTY SOUTH LA SALLE STREET

CHICAGO, ILLINOIS 60675

TELEPHONE (312) 630-6000

BARRY G. HASTINGS
SENIOR EXECUTIVE VICE PRESIDENT

June 30, 1993

FEDERAL EXPRESS
Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washingson, D.C. 20515

Re: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

The Northern Trust Company submits this statement in support of the provisions of Section 623 of H.R. 13 which are intended to permit the tax-free conversion of common trust funds to registered mutual funds.

The Northern Trust Company, a member of the Federal Reserve System, is an Illinois chartered bank formed in 1889 that, itself and through its affiliates, employs over 6,000 persons. As of December 31, 1992, Northern's Trust Department administered in various capacities approximately $393 billion of assets, including over $55 billion of assets for which Northern had investment management responsibility. The assets managed included over $2 billion of assets held in common trust funds for various fiduciary accounts.

We believe that the conversion provisions of H.R. 13 will enhance our ability to better serve those customers who currently are able to participate in the common trust funds, and will enable us to make the investment vehicles formed by conversion available to a broader range of our customers. At present, many customers are attracted to a variety of mutual fund products offered by other financial service organizations. A safe and sound banking industry depends upon the financial health of its members, and their health in turn depends upon their ability to offer competitive products desired by their customers.

The conversion of common trust funds would result in no loss of consumer protection, since the resulting mutual funds will be regulated by the Securities and Exchange Commission and state securities regulators under highly developed regulatory systems. In addition, although the legislation permits "tax free" conversion, enactment would not result in any loss of revenue for the U.S. Treasury, since without the legislation, our customers would not consent to a conversion to mutual funds.

Respectfully,

Barry G. Hastings
Senior Executive Vice President

CC: The Honorable Dan Rostenkowski, Chairman, House Ways and Means Committee
The Honorable Charles Rangel, Chairman, Select Revenue Measures Subcommittee
The Honorable Philip Crane
The Honorable Mel Reynolds
James D. McLaughlin

OLD KENT

Old Kent Bank and Trust Company
One Vandenberg Center
Grand Rapids, Michigan 49503

E. PHILIP FARLEY
Executive Vice President
Trust Services
(616) 771-5662

June 21, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

Old Kent Bank and Trust Company supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measures to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in the vehicle, due to tax requirements to distribute virtually all the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customers base, thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Respectfully submitted,

OLD KENT BANK AND TRUST COMPANY

Phil Farley

E. Philip Farley

EPF:sm

cc: Dan Rosenkowski, Chairman, House Ways and Means Committee
Sander Levin, House Ways and Means Committee

Security Trust

2 NORTH CHARLES STREET
PO BOX 995
BALTIMORE MARYLAND 21203-0995
410-244-5660

TIMOTHY J. HYNES, III
SENIOR VICE PRESIDENT

June 28, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Statement for Inclusion in the Written Record of the Printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, well regulated, investment choices. Furthermore, the provision will enable banks to both serve better as well as enhance their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Among the key benefits of mutual funds from the perspective of investor protection is that they are highly regulated vehicles both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code. As an example, strict diversification of the assets of mutual funds is required.

Security Trust Company, N.A., therefore, supports the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. We believe this provision will benefit customers and the banking industry, as well as enhance government regulation.

Sincerely,

Timothy J. Hynes III

cc: D. Rostenkowski, Chairman, House Ways and Means Committee
B. Cardin, House Ways and Means Committee

Texas Commerce
Investment Management
Company

H. MITCHELL HARPER, CFA
Managing Director
(713) 236-4442

June 24, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

As a consumer of banking services, I support the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. This provision will benefit millions of consumers like me by providing them the choice of several investment vehicles that can generate a more reasonable return on dollars invested than is generally currently available to them at banks.

Mutual funds are a highly regulated vehicle. Due to the stringent regulation of these funds by the Securities and Exchange Commission, a high level of safety is provided to the consumer.

Passage of this provision will enable banks to maintain their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Sincerely,

H. Mitchell Harper

HMH:pes

P.O. Box 2558 • Houston, Texas 77252-8032 • Telefax: (713) 236-5803

Texas Commerce
Investment Management
Company

WILLIAM O. LESZINSKE
President and
Chief Investment Officer
(713) 216-4521

June 23, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Statement for Inclusion in the written record of the printed Ways and Means Select Revenue Measures Subcommittee Hearings

Dear Chief Counsel Mays:

I, as President and Chief Investment Officer of Texas Commerce Investment Management Company support the adoption of the provision to permit the tax-free conversion of common trust funds to one or more proprietary or nonproprietary mutual funds. I believe this provision will provide a step toward enhancing the stability and economic health of the banking industry, resulting in benefits to the nation as a whole.

The measure will also benefit consumers by providing them the choice of a savings vehicle that can generate a more reasonable return on dollars invested than is generally currently available to them at the banks. A recent survey indicated that 87% of households surveyed prefer to look to their local bank for financial advice. Currently, however, bank certificates of deposit are not providing an acceptable return on investment for many bank customers. Bank-provided mutual funds would provide such a vehicle.

Among the key benefits of mutual funds from the Government's perspective of investor protection is that they are highly regulated. The mutual fund as an investment alternative provides a highly regulated vehicle (both under the Investment Company Act of 1940 and Subchapter M of the Internal Revenue Code) for stimulating saving while providing a more reasonable return to a greater number of bank customers. Due to the stringent regulation of this vehicle, safety measure to the investor are an inherent part of the product. For example, strict diversification of the assets of mutual funds is required. In addition there is no shareholder tax deferral inherent in the vehicle, due to tax requirements to distribute virtually all the income to the shareholders on an annual basis.

Adopting the provision allowing banks the tax-free conversion of common trust funds to mutual funds will provide bank customers with a wider range of acceptable, while regulated, investment choices. Furthermore, the provision will enable banks to maintain their customer base; thus, supporting the economic health of the entire banking industry and the nation's economic recovery process.

Sincerely,

W.O. Leszinske

Mr. William O. Leszinske

/pes

TESTIMONY OF ROBERT K. SHERIDAN
PRESIDENT, SAVINGS BANK LIFE INSURANCE COMPANY
OF MASSACHUSETTS
BEFORE THE
SELECT REVENUE MEASURES SUBCOMMITTEE
HOUSE WAYS AND MEANS COMMITTEE
JUNE 17, 1993

The Savings Bank Life Insurance Company of Massachusetts ("SBLI") provides low-cost life insurance consistent with absolute safety to the citizens of Massachusetts. Legislative language is being sought which would clarify the tax consequences of the consolidation of the SBLI into a stock life insurance company pursuant to state legislation. The issue comes down to whether or not an additional policyholder dividend that is to be paid over a twelve year period is treated the same as any other policyholder dividend as was the intention of the state legislation.

The sole reason there is any question is because of the unique nature of SBLI. In truth, it is unlike any other company in the country. Massachusetts SBLI was created by an act of the Massachusetts Legislature in 1907 as the brainchild of Justice Louis D. Brandeis. The enabling legislation represented one of the earliest efforts at progressive, consumer reform. Justice Brandeis felt that there was much waste in the prevailing system of selling life insurance. In response, he devised a plan whereby life insurance could be purchased at a cost much lower than that generally available. The vision for SBLI was a system of over the counter sales with reduced costs by eliminating sales commissions and other ancillary expenses. Justice Brandeis' selection of mutual savings banks can be traced to history as at that time savings banks were the banking institutions of low income and immigrant consumers. Experience has shown that the Brandeis experiment has even exceeded the greatest of expectations. Consumers Report made a study of insurance company costs in the United States and concluded that before any Massachusetts citizen purchases life insurance, they consider SBLI, noting that: "Massachusetts Savings Bank Life Insurance in particular is a model for what all life insurance ought to be". Many other consumer-oriented publications have similarly endorsed SBLI.

Presently, SBLI has over 500,000 policies and $12 billion in in-force insurance. While we have the full range of life insurance products our yearly renewal term insurance has grown in popularity and does represent about 80% of current issues. An example of our rates for a 30 year old non-smoker should show why the product is so popular -- $99 for $100,000, $180 for $250,000 and $315 for $500,000. This policy, as virtually all of our policies is participating, meaning that dividends can be expected at some point in time.

The deregulation of the banking industry posed a significant challenge to the prior SBLI system. During the 1980's, many savings banks converted to stock ownership which produced a natural conflict between a stock bank and a non-stock life insurance department. Moreover, as a stock entity, such banks were subject to acquisition and if a non-savings bank were involved, SBLI outlets would have diminished. Desirous of preserving and protecting SBLI for future generations of Massachusetts consumers and wanting to make available low-cost life insurance through a banking network, legislative and consumer leaders overhauled the SBLI governing statute in 1990.

The plan consolidated the fifty separate life insurance departments into a closely held stock company. All conceivable so-called home office functions, including the underwriting and servicing of policies and the investment of premiums, were transferred to the consolidated entity. Almost immediately, the efficiencies of consolidation manifested themselves as after the first year of operation in 1992, the restructured SBLI realized a 34.1% reduction in general insurance expenses. Further aspects of the plan included the repeal of artificially capped policy size limits and the creation of a public watchdog group whose mandate was to see that SBLI remained faithful to safe, low-cost life insurance.

In effecting the consolidation, the SBLI banks received stock in the new company roughly in proportion to the size of the surplus in the life insurance department. The size of the stock distribution sought to equitably recognize the degree of subsidy and support that was provided by any host savings bank. To buttress the provision of low-cost insurance, an additional dividend was prescribed to be paid out to policyholders over a twelve-year period. This dividend roughly equated to the present value of 60% of the total combined surplus and constituted amounts made excess by operating one consolidated entity as opposed to fifty small life insurance department.

The issue was raised as to whether such dividend is the same as the payout of surplus to policyholders for their ownership interest in a conventional demutualization. In a typical demutualization, policyholders receive a payment for their legal ownership interest as it is considered a redemption.

Unfortunately, given the sui generis nature of SBLI, conversion models cannot be followed. If ownership is the controlling factor, then the normal attributes of ownership were not held by a SBLI policyholder: 1) there was no right to vote; 2) the right to participate to earnings was qualified; and 3) there was no right to participate in the distribution of assets.

The prior regulatory body, the Division of Savings Bank Life Insurance, and the Massachusetts Legislature carefully analyzed the status of policyholders and concluded that SBLI policyholders did not have an equity interest in the surplus of their life insurance department. They further determined, even to the extent of receiving judicial clearance, that the conversion/consolidation could be effected without any vote of policyholders, that there was no requirement to distribute surplus, and that policyholders were not entitled to any stock.

For the reasons cited above, the payment of the additional annual dividend based on the combined surplus should not be construed as payment for the redemption of any ownership interest, but rather represents a dividend payment as it would be reflective of earnings, mortality and expenses like any other dividend. Moreover, the legislation made clear that a policyholder must keep his policy in force so in the case of a lapse or surrender such individual would cease to be eligible for the dividend.

While it is crystal clear in our opinion that the additional dividend is the same as any other dividend pursuant to SBLI operations, our unique fact pattern did not permit Internal Revenue Service guidance through a private letter ruling. Among developments considered was the pending regular demutualization of the Equitable Life Assurance Society in New York so the IRS was disinclined to create any exceptions to standard practice, however meritorious the facts or arguments.

Legislative clarification was decided upon as the best route to give meaning to the intent of Massachusetts law.

The Joint Tax Committee has estimated a revenue loss of $19 million over five years if the additional dividend was legally found to be a non-deductible redemption of a propriety interest as opposed to a deductible repayment of a creditor interest. This estimate must be placed in perspective. In 1992, the federal government realized more than $5 million more in federal income taxes from SBLI since the small business deduction ended due to corporate reorganization. Ongoing, SBLI will pay more in federal income taxes as one large taxpayer in contrast to multiple smaller ones. This permanent revenue windfall to the federal government should more than mitigate the impact of clarifying the additional dividend. We understand that the Joint Tax Committee's methodology prevents taking into account any revenue enhancements. For purposes of revenue estimates, we do, however, understand that a revenue offset has been identified.

In summation, we believe that the amendment merely clarifies the state of the law and effectuates the intended meaning of the Massachusetts legislation. In so doing, the legitimate interests of SBLI policyholders and stockholders are acknowledged. Accordingly, we urge approval of Representative Neal's amendment.

We appreciate your consideration and attention.

Statement of the
Securities Industry Association
to the Subcommittee on Select Revenue Measures,
Committee on Ways and Means
U.S. House of Representatives
June 24, 1993

Mr. Chairman and members of the Subcommittee: I am Marc E. Lackritz, President of the Securities Industry Association ("SIA"). SIA is the securities industry's trade association representing the business interests of nearly 700 securities brokerage and investment banking firms in the U.S. and Canada. Collectively, they account for more than 90% of securities activity in North America.

I appreciate this opportunity to testify before the subcommittee in support of the proposal to amend section 956 of the Internal Revenue Code (the "Code") to provide the same treatment for loans made to unrelated U.S. persons and certain related issues. SIA also supports H.R. 2065 and other proposals to provide specified tax treatment for financial asset securitization investment trusts.

Section 956 - Investment in United States Property

The proposed amendment to section 956 of the Code would allow investments made by a controlled foreign corporation ("CFC")[1] in the obligations of unrelated non-corporate United States persons to be treated in the same way that present law treats a CFC's investments in the obligations of unrelated U.S. corporations. SIA supports this proposal.

Under present law, the active business earnings of a CFC generally are not subject to U.S. tax until they are distributed. As part of the anti-deferral regime of current law, however, section 951 of the Code requires that a U.S. Shareholder of a CFC include in income currently the U.S. Shareholder's pro rata share of the CFC's increase in earnings invested in "United States property," as determined under section 956. Legislative history indicates that earnings invested in United States property are taxed currently to U.S. Shareholders "on the grounds that this is substantially equivalent to a dividend paid to" U.S. Shareholders.[2]

Under section 956, "United States property" generally includes obligations of any U.S. person (i.e., U.S. corporations, partnerships, individuals, trusts and estates). Under a provision enacted by the Tax Reform Act of 1976, now codified as section 956(b) (2) (F), obligations of a U.S. corporation that are unrelated to the CFC (i.e., a U.S. corporation that is neither a U.S. Shareholder of the CFC nor 25% or more owned by U.S. Shareholders of the CFC) are not treated as United States property. Thus, for example, under current law, the purchase by a CFC of debt securities issued by, or the making of a loan by a CFC to, an unrelated U.S. corporation will not be considered to be an investment in United States property for purposes of determining whether there has been an increase in the CFC's earnings invested in United States property. The legislative history indicates that this exception was provided because treating investments by a CFC in the obligations of unrelated U.S. persons as a repatriation of earnings is "too broad" and would be "detrimental to the promotion of investments in the United States," as this would, for example, encourage a CFC looking for a temporary investment of its working capital to purchase foreign rather than U.S. obligations.[3] Furthermore, as the legislative history suggests, a CFC's investment in the obligations of unrelated U.S. persons should not be viewed as "substantially the equivalent of a dividend" paid to the CFC's U.S. Shareholders.[4] The legislative history does not, however, explain why the statutory language does not provide for the same exception for investments in the obligations of U.S. persons other than corporations. There does not appear to be a reason for this discrepancy, since the same legislative purposes that prompted the exception for unrelated U.S. corporations also apply in the case of non-corporate persons.

The proposal to amend section 956 would provide an exception to the definition of "United States property" for any obligation of an unrelated non-corporate United States person (i.e., U.S. partnerships, individuals, trusts and estates). We understand that it would be appropriate to define an "unrelated" non-corporate U.S. person in a manner consistent with the definition of unrelated U.S. corporations under the present law exception for obligations of unrelated U.S. corporations. The proposal would thus simply extend the present law exception for obligations of unrelated U.S. corporations to obligations of unrelated non-corporate U.S. persons. This would eliminate the anomalous discrepancy under present law between investments in the obligations of U.S. corporations and non-corporate U.S. persons, thus allowing the lending and borrowing decisions of securities firms and other taxpayers to be made based on economic considerations without tax biases. For example, the proposal would enable subsidiaries of U.S. securities firms to conduct the securities business more efficiently by permitting them to make loans (including loans in connection with the purchase of securities and loans collateralized by securities) to, or make a market in, the obligations of non-corporate persons. The proposal would also, for example, permit U.S. securities firms and other taxpayers that are organized in non-corporate form, to gain access to the funds available to be invested by foreign subsidiaries of unrelated U.S. multinationals.

On a related issue, SIA believes that section 956 should be amended to provide for an exception from the definition of "United States property" for obligations that arise in connection with the active conduct of a banking or other financing business. Under current law, the exceptions from the definition of "United States property" include, in addition to the obligations of unrelated U.S. corporations discussed above, obligations of a U.S. person arising in the ordinary course of business in connection with the sale or processing of property. In addition, Treasury Regulations under section 956 provide that the term "obligation" does not include any obligation of a U.S. person arising in the ordinary course of business in connection with the provision of services by the CFC to the U.S.[5] These exclusions are consistent with the legislative history of section 956, which indicates that Congress intended to exclude transactions arising in the ordinary course of business from the application of that section because they "are believed to be normal commercial transactions without intention to permit the funds to remain in the United States indefinitely" (emphasis added).[6]

In the ordinary course of the financial services business, financial services entities engage in normal commercial transactions that may result in the acquisition by a CFC of an obligation of a U.S. person that would be subject to section 956 under current law.[7] Because these transactions arise in the ordinary course of business and are on arm's length terms, they are not substantially equivalent to a dividend. Further, there is no intention to permit the funds to remain in the United States indefinitely and generally no increase in the assets of the United States person. However, current section 956 limits the ability of financial services businesses to engage in these normal commercial transactions and therefore is extremely disruptive to the ordinary operation of financial services businesses.

SIA believes that the transactions that arise in the ordinary course of a financial services business should be excluded from the purview of section 956. Such an exclusion would be consistent with the legislative history of section 956 and would put CFCs that are financial services entities on a "level playing field" with other CFCs with respect to their "normal commercial transactions."

Financial Asset Securitization Investment Trusts

Mr. Chairman, the SIA fully supports the enactment of H.R. 2065. This bill would authorize a new special purpose vehicle to facilitate the securitization of loans, trade receivables and other financial assets in much the same way that the REMIC provisions facilitated the securitization of residential and commercial mortgage loans. The enactment of this legislation would remove certain existing tax impediments that limit the efficient securitization of receivables and help make securitization easier by creating a new pass-through structure specifically designed for loan securitization. I want to commend Representatives Peter Hoagland (D-NE) and Clay Shaw (R-FL) for introducing the FASIT legislation.

The enactment of this legislation creating the Financial Asset Securitization Investment Trust, or FASIT, would have a positive impact on the economy by increasing the supply of credit available for lending and liquidity in the market place. The increase in liquidity and the availability of credit would be particularly beneficial to small and medium size businesses. The passage of H.R. 2065 would also help increase the safety and soundness of the nation's financial system and decrease the private sector's reliance on explicit or implicit backing of the Federal Deposit Insurance Corporation and other federal regulatory agencies.

H.R. 2065 deserves the careful consideration of this subcommittee. The SIA and the other members of the Coalition for Asset Backed Securities stand ready to work with you and other interested parties to perfect this bill.

Thank you for the opportunity to present our view on this legislation.

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[1] A "controlled foreign corporation," as defined in Section 957 of the Code, is any foreign corporation more than 50% of the total combined voting power or total value in which is owned, actually or constructively, by U.S. persons that own, actually or constructively, 10% or more of the total combined voting power of the corporation ("U.S. Shareholders").

[2] S. Rep. No. 1881, 87th Cong., 2d Sess. (1962), 1962-3 C.B. 794.

[3] See S. Rep. No. 94-938, 94th Cong., 2d Sess. (1976), 225-26, reprinted 1976-3 C.B. 263-64; see also Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1976, 228-29, reprinted 1976-3 C.B. 240-41.

[4] Id.

[5] Treas. Reg. section 1.956-2T(d)(2)(i)(B)

[6] Id.

[7] These transactions include, for example, (i) repos where a CFC provides collateralized financing to United States persons, (ii) posting of cash collateral by the CFC against securities it borrows, (iii) posting of initial cash margin by the CFC with respect to futures contracts, and (iv) posting of cash collateral against an increase in the potential liability of the CFC under derivative instruments (such as options).

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Statement of the CLHIA Subcommittee on U.S. Taxation[1] in Support of HR 1228: Proposed Modifications to Section 842(b)

Hearing before the Select Revenue Measures Subcommittee of the House Ways and Means Committee: JUNE 17, 1993

This statement is in support of enactment of HR 1228, which is a bill to modify and correct the tax treatment of foreign insurance companies operating in the United States. [Item #3, Insurance Items]

I. SUMMARY

Prior to 1988, the U.S. operations of a foreign insurance company were taxed under section 842 of Subchapter L in generally the same manner as a domestic insurance company. In 1987, pursuant to the Omnibus Budget Reconciliation Act (the 1987 Tax Act), section 842(b) was added to the Internal Revenue Code (the Code). Section 842(b) taxes foreign insurance companies based on a formulary minimum amount of net investment income and surplus. Domestic insurance companies are not subject to any similar formulary minimum investment income or surplus requirement. Domestic insurance companies pay tax each year based upon their actual net investment income and surplus.

Currently, under section 842(b), in each taxable year, a foreign insurance company is taxable on the greater of (a) its actual effectively connected net investment income **(Actual Investment Income)**, or (b) a formulary minimum effectively connected net investment income **(Formulary Minimum)**, calculated using a formula that takes into account the foreign insurance company's U.S. insurance liabilities, the average asset/liability ratio of U.S. insurance companies and the average net investment yield earned by U.S. insurance companies. At the present time, the computation of the U.S. company averages is calculated by Treasury based on 2 **year old** domestic insurance company financial statement data.

HR 1228 would make section 842(b) operate in a fairer way by eliminating:

(a) the distortion caused by comparing a foreign insurance company's current year actual investment results with results calculated using domestic insurance company data from 2 years prior to the current year,

(b) the distortion caused by comparing a foreign company's actual investment results calculated on a tax basis with the investment results of domestic companies, calculated on a financial statement basis, and

(c) the distortion caused by the lack of an appropriate carryover account to adjust for year-to-year fluctuations in investment yields and differences in trading practices.

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[1] This statement is submitted on behalf of the Canadian Life and Health Insurance Association (CLHIA) Subcommittee on U.S. Federal Income Taxation (the Subcommittee). The members of the Subcommittee represent Canadian life insurance companies each of which operates a life insurance trade or business in the United States in branch form. This statement has been issued by Raymond L. Britt, Jr., Esq. and Mary V. Harcar, Esq. Both Raymond L. Britt, Jr. and Mary V. Harcar have registered as an agent of The Manufacturers Life Insurance Company, 200 Bloor Street East, Toronto, Ontario, Canada M4W 1E5, under the Foreign Agents Registration Act. Mary V. Harcar has registered as an agent of the CLHIA. Registration materials are available for inspection at the Department of Justice, Washington, D.C. Such registration does not indicate approval by the U.S. Government of the contents of this statement.

II. CURRENT LAW UNDER SECTION 842(b)

Pursuant to section 842(b), if a foreign insurance company's Actual Investment Income for the year is less than the Formulary Minimum, the excess of the Formulary Minimum over Actual Investment Income is added to the foreign company's income for purposes of determining its Life Insurance Company Taxable Income (LICTI) for the year.[2]

In any year, the Formulary Minimum is calculated as the product of "U.S. Required Assets" and the "Domestic Investment Yield", where:

a) **U.S. Required Assets** is the product of the foreign company's total mean insurance liabilities and the Domestic Asset/Liability Percentage;

b) **Domestic Asset/Liability Percentage** is calculated as the domestic companies' total mean assets divided by the domestic companies' total mean insurance liabilities; and

c) **Domestic Investment Yield** is calculated as the domestic companies' total net investment income divided by the domestic companies' total mean assets.

Both the Domestic Asset/Liability Percentage and the Domestic Investment Yield are calculated by the Treasury Department (Treasury) using "representative data" for domestic insurance companies. Since Treasury estimated that it would take approximately 2 years to gather the relevant data needed to calculate these averages, section 842(c)(4) specifies the use of representative data from the "second preceding taxable year". A significant amount of the distortion inherent in section 842(b) is precipitated by this "2 year lag".

In addition, under current law, distortion is also caused by the fact that the average Domestic Asset/Liability percentage and Domestic Investment Yield are calculated using financial statement data rather than tax return data.

Lastly, section 842(b) is further distorted by the absence of an appropriate carryover account to adjust for year-to-year differences in an individual insurance company's investment performance compared to the average. These differences occur because of variations in the mix of assets held by, and the trading practices of, the individual insurance company compared to the average U.S. company rather than because of a plan to minimize investment income.

All of these distortions are discussed in more detail below:

(a) Distortion Caused by the 2 Year Lag

The chart below shows the Domestic Asset/Liability and Investment Yield Percentages announced by Treasury in the indicated notices. These percentages are used by a foreign life insurance company for the taxable years beginning after December 31, 1987.

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[2] In addition, if the foreign company is a mutual life insurance company, and its "U.S. Required Assets" exceed its actual U.S. assets, the excess will be added to the company's equity base for purposes of calculating its section 809 Equity Adjustment for the year.

Treasury-Announced Life Insurance Company Percentages

Percentages for use in Taxable Year	Domestic Asset/ Liability Percentage (Surplus %)	Domestic Investment Yield	Date of IRS Notice	Percentages Based on Data From:
1988	120.5%[3]	10.0%	IRS Notice 89-96 (8-8-89)	1986
1989	117.2%	8.7%	IRS Notice 90-13 (1-17-90)	1987
1990	116.5%	8.8%	IRS Notice 90-67 (11-13-90)	1988
1991	115.1%	9.0%	Rev. Proc. 92-27 (3-23-92)	1989
1992	113.6%	8.3%	IRS Proc. 92-25 (11-24-92)	1990

Evidence of the distortion inherent in the current law is obvious by reference to the Surplus and Yield Percentage chart above. The effect of the 2 year lag on the Minimum Yield Percentages dramatically illustrates the need for correction. For example, in 1988, the required Minimum Domestic Investment Yield announced by Treasury was 10.0%. This was calculated by Treasury by reference to the 1986 NAIC Annual Statements[4] of domestic insurance companies. However, the actual 1988 average yield for domestic life insurance companies, calculated by reference to 1988 NAIC Annual Statements, was 8.8%. As a result, for the 1988 year, section 842(b) taxes foreign insurance companies based on a 10% yield even though domestic companies only earned 8.8%.

This 120 basis point difference is particularly onerous in view of the amount of assets held by life insurance companies. For example, consider the case of a foreign insurance company which held $7 billion in assets, satisfied the Required Asset/Liability Percentage, and earned an 8.8% net investment yield on its assets for 1988. Under current law, because of this 120 basis point distortion caused by the 2 year lag in investment yields, **$84 MILLION** of taxable income would be imputed to the company for the 1988 tax year.[5] This attribution of $84 million of taxable investment income would occur despite the fact that the company's investment performance and surplus ratio were consistent with the industry average for the same year.

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[3] Treasury has admitted this percentage is 3% too high but refused to correct the number stating that the original surplus percentage was "...determined using the best information available to Treasury at that time." See IRS Notice 90-13.

[4] The NAIC Annual Statement is the annual statement form approved by the National Association of Insurance Commissioners.

[5] Note that the income imputed by section 842(b) would in fact exceed this $84 million since this example ignores the distortive impact of the 2 year lag in the minimum surplus requirement in section 842(b). In 1988, the required surplus percentage was 120.5% (as calculated by reference to 1986 domestic insurance company financial statement data). However, when calculated by reference to 1988 financial statements, the surplus percentage was 116.5%. As in the case of the domestic yield requirement, if the company had a surplus percentage for 1988 equal to the domestic average for the same year [i.e., 116.5%], section 842(b) would tax the company based on a surplus ratio of 120.5%. This would result in imputed surplus which would be subject to the minimum yield requirements of section 842(b), thus, further exacerbating the distortive impact of section 842(b). In contrast, domestic companies are not subject to any similar requirements to hold minimum surplus or to earn a minimum yield.

The impact of the 2 year lag is made even worse because section 842(b) taxes a company in each year on the greater of the Actual Investment Income of the company or the Formulary Minimum.[6] In years when the Formulary Minimum is greater than the company earned, the company is taxed on the Formulary Minimum. In years when the Formulary Minimum is less than the company earned, the company is taxed on its Actual Investment Income. Since investment rates fluctuate over time, the combination of the 2 year lag and the "greater of" rule produces an extremely unfair result. In years when interest rates are dropping (reducing Actual Investment Income), the company will be subject to tax based upon the Formulary Minimum. However, in years when interest rates are rising, section 842(b) will tax the higher Actual Investment Income. This is a perfect example of the tax collector being able to "have her cake and eat it too!"

(b) Distortion Caused by the Use of Financial Statement Data

Currently, section 842(c)(4) states that Treasury should calculate the Domestic Asset/Liability Percentage and the Domestic Investment Yield based upon "representative data" with respect to domestic insurance companies. In the Treasury Notices referenced above, Treasury stated that it utilized NAIC Annual Statement data to determine both the Domestic Asset/Liability Percentage and the Domestic Investment Yield. Tax return net investment income can vary significantly from NAIC Annual Statement net investment income.[7] Using NAIC Annual Statement data for section 842(b) purposes has the effect of taxing foreign life insurance companies based upon the financial statement net investment income of domestic life insurance companies even though there is no assurance that the domestic life insurance companies have been or will be actually subject to tax on that amount of net investment income.

The most significant difference between NAIC Annual Statement data and tax return data is in the calculation of net capital gains and losses. For NAIC Annual Statement purposes, gains and losses are calculated using NAIC asset values, not actual costs. NAIC asset values are subject to write-downs and write-ups, with conservative guidelines mandated for use in the preparation of the NAIC Annual Statement dictating more write-downs than write-ups. This results in a book value which is generally less than tax cost and therefore NAIC Annual Statement capital gains greater than capital gains on a tax basis. Such overstatements inflate the Domestic Investment Yield. This inflation of the Domestic Investment Yield is inappropriate since U.S. insurance companies are not being taxed on the gains calculated in this manner.

(c) Distortion Caused by the Lack of a Carryover Account

Another problem with section 842(b) involves the whipsaw effect of section 842(b)'s year-by-year comparison of the required Formulary Minimum and the company's Actual Investment

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[6] Under section 842(b), a company cannot "recover" from the distortive impact of the 2 year lag. A "recovery" might be theoretically possible if section 842(b) consistently and exclusively applied a formulary minimum amount of net investment income. Then, at least a taxpayer would ultimately get the benefit of falling interest rates. However, since section 842(b) applies a "greater of" rule to each year independently, taxable investment income under section 842(b) never correctly reflects lower actual investment yields.

[7] Congress recognized this in section 56(f)(1) which provides that, for taxable years 1987, 1988, and 1989, a corporation must increase its alternative minimum taxable income by 50 percent of the difference between financial statement income, as adjusted, and alternative minimum taxable income computed without regard to section 56(f)(1).

Income. Under current law, in any taxable year, a foreign insurance company is subject to tax on the greater of Actual Investment Income and Formulary Minimum, with the Formulary Minimum being calculated using domestic company financial statement data from 2 years previous to the current year. This "greater of" approach will result in the foreign insurance company being subject to tax on net investment income greater than either it or a representative domestic insurance company earns over any measured period of time.

For example, if foreign company investment yields over time are identical to domestic company investment yields during the same period but differ on a year-by-year basis, the foreign company will be subject to tax on a greater cumulative yield over the period than either it or the representative domestic companies earned during that period.[8] This results from the "greater of" approach of section 842(b) exacerbated by the 2 year lag and data collection problems. Small differences in required surplus and investment yield can create large distortions in the calculated Formulary Minimum under section 842(b). This distortive impact can create a U.S. tax liability for a foreign insurance company that exceeds its U.S. net effectively connected income.

Current section 842(d)(2) provides that Treasury shall issue regulations on this issue. If an appropriate carryover account were provided for in these regulations, the magnitude of the distortion inherent in section 842(b) would be at least somewhat reduced.

III. PROPOSED CHANGES TO SECTION 842(b)

The correction of section 842(b) proposed by HR 1228 (and its identical companion bill in the Senate, S 675) does not change the fundamental concept of section 842(b) but corrects some of the technical problems, distortions and inequities. HR 1228:

(1) requires that the Domestic Asset/Liability Percentage and the Domestic Net Investment Yield be calculated using same year data, with such data being tax return data to the extent possible, and

(2) establishes an appropriate carryover account to ensure the payment of tax on the greater of cumulative Formulary Minimum or cumulative Actual Investment Income as opposed to the greater of Formulary Minimum or Actual Investment Income on a year-by-year basis.

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[8] A simple example shows the "heads I win, tails you lose" approach of section 842(b):

	Actual Yield of Foreign Company	Average Domestic Investment Yield	Yield Under "Greater of" Approach
Y_1	4	6	6
Y_2	6	4	6
	10	10	12

In this example (which ignores the 2 year lag), the foreign insurance company will be taxed on $6 in both year 1 and year 2 despite the fact that the company's actual income over the Y_1 - Y_2 period is the same as the total domestic average over the period.

Thus, because of the "greater of" aspect of section 842(b), the foreign insurance company will be taxed on $12 of taxable income over the Y_1 - Y_2 period when it actually earned $10 which is exactly the same as the domestic insurance company average yield for the same period. This is another example of the discrimination inherent in the operation of section 842(b). Needless to say, the discrimination resulting from the "greater of" approach is further exacerbated by the 2 year lag.

HR 1228 clarifies that the foreign company will be subject to tax over the cumulative period on the greater of what it actually earns over that period and what the average domestic company earns over that same period. The carryover account would keep track, on a yearly basis, of the cumulative difference between Actual Investment Income and Formulary Minimum Investment Income.

Mechanically, under HR 1228, a company would pay U.S. tax in the current year based upon Actual Investment Income. Two years later, when Treasury has calculated the domestic averages for that prior taxable year, then the foreign insurance company would compute and compare the cumulative Formulary Minimum to cumulative Actual Investment Income. If the cumulative Formulary Minimum exceeds cumulative Actual Investment Income, then the company would pay tax on the amount of any shortfall and would also pay statutory interest on the amount of the additional tax.

A carryover account is needed even though the amending legislation eliminates the use of 2 year old data. The carryover account is needed to account for year-to-year differences in trading practices, investment performance, portfolio mix, and differences in the timing of realization of capital gains and losses among insurance companies. These variations can result in significant year-to-year differences between the domestic company averages and the individual foreign company yields, even where the yields are identical on a cumulative basis over time.

It should be noted that even after enactment of the proposed changes to section 842(b) in HR 1228, the U.S. operations of foreign insurance companies will remain subject to a formulary minimum tax. The benchmark for imposing that tax will simply be made fairer, and less distorted.

IV. SECTION 842(b) AND U.S. INCOME TAX TREATIES

The Conference Report to the 1987 Tax Act specifies that if section 842(b) is found to be in conflict with any existing U.S. Income Tax Treaty, section 842(b) is **NOT** intended to override the treaty. H.R. Rep. No. 100-495, 100th Cong., 1st Sess., 983 (1987) (the 1987 Conference Report). The 1987 Conference Report states that "...the Treasury Department believes that the provision does not violate any treaty now in effect".[9] This position was reiterated in the testimony of Leslie B. Samuels, Assistant Secretary (Tax Policy), Department of the Treasury, June 22, 1993 (the 1993 Treasury Testimony).[10]

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[9] The 1987 Conference Report states (in part): "The conferees understand, however, that the Treasury Department believes that the provision does not violate any treaty now in effect. In particular, the Treasury Department believes that the provision does not violate treaty requirements that foreign corporations be taxed only on profits derived from the assets or activities of a corporation's U.S. permanent establishment, that permanent establishments of foreign corporations be taxed only on profits the permanent establishments might be expected to make were they separate enterprises dealing independently with the foreign corporations of which they are a part, or that permanent establishments of foreign corporations be taxed in a manner no more burdensome than the manner in which domestic corporations in the same circumstances are taxed. The conferees similarly believe that this provision does not violate any treaty now in effect". See the 1987 Conference Report, 983.

[10] This 1993 Treasury Testimony was provided at a June 22, 1993 hearing before the Select Revenue Measures Subcommittee of the House Ways & Means Committee. The 1993 Treasury Testimony states (in part) that "[w]hile the provisions of current law do not violate our treaty obligations, **we believe the proposed amendments [referring to HR 1228] could improve the operation of the statute."** See 1993 Treasury Testimony, p. 8. [Emphasis added.]

However, it is clear that in fact section 842(b) **DOES VIOLATE** U.S. income tax treaties in the following ways:

1. Most U.S. Income Tax Treaties include a non-discrimination article. The test for discrimination generally examines whether similarly situated domestic companies are subject to the same or a similar provision. No similar formulary minimum tax is imposed on domestic insurance companies. Domestic insurance companies pay tax only on their Actual Investment Income despite the fact that, by the nature of averaging, most domestic insurance companies do not meet the section 842(b) minimums.
2. Under most U.S. Income Tax Treaties, a foreign company pays tax based upon actual business profits. The section 842(b) formula fails to relate in any way to the actual profits of the foreign insurance company.
3. Even if a formula to impute income to a foreign insurance company were acceptable under U.S. income tax treaties, the distortions discussed previously produce clear evidence of the discrimination inherent in the current section 842(b).

If domestic companies were subject to section 842(b), their tax burden would be **SIGNIFICANTLY** increased. For example, if section 842(b) had applied to Prudential Insurance Company of America ("Prudential") in 1988, the Subcommittee estimates that Prudential's 1988 Formulary Minimum would have exceeded its 1988 NAIC Annual Statement net investment income[11] by **$1.5 BILLION**. As a result, Prudential's 1988 taxable income would have been increased by $1.5 billion, which is an enormous amount given that its pre-tax net income as reported in its NAIC Annual Statement was only $1.4 billion! Similarly, for the fourteen (14) largest U.S. life insurance companies, their aggregate 1988 Formulary Minimum would have exceeded their NAIC Annual Statement net investment income by over **$8 BILLION**, compared to their aggregate reported pre-tax net income of $5.8 billion. This provides conclusive evidence of the discrimination inherent in section 842(b).

Thus, contrary to the Treasury view outlined in the 1987 Conference Report and the 1993 Treasury Testimony, section 842(b) imposes a distorted and plainly more costly and burdensome tax on the U.S. operations of foreign life insurance companies than is imposed on domestic insurance companies.[12] The section 842(b) minimum tax is imposed without regard to the actual surplus and investment income of the permanent establishment. Accordingly, section 842(b) would easily be found to violate the Business Profits and Non-Discrimination articles of U.S. Income Tax Treaties.

V. WORLDWIDE YIELD ELECTION DOES NOT ELIMINATE TREATY VIOLATION

The provision in section 842(b)(4) which allows a company to elect to use its "worldwide net investment yield" in lieu of the Domestic Investment Yield in the calculation of the Formulary Minimum does not eliminate these treaty violations. The Subcommittee submits that the underlying concept of section 842(b) (i.e., that you can split the investment income and underwriting income of a life insurance company) is valid only if a company is operating in a single currency and in a single economy. Even then, the concept operates only theoretically and only based upon the use of an agreed-upon formula for calculating net investment income.

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[11] This calculation is based on the assumption that Prudential's NAIC Annual Statement net investment income is equal to its Actual Investment Income. This assumption is consistent with Treasury's calculation of the Domestic Investment Yield which is also based on NAIC investment income as opposed to tax return data.

[12] While domestic insurance companies are taxed on their worldwide income, they are eligible to deduct worldwide expenses and are eligible for foreign tax credits (which foreign companies are not). Domestic insurance companies are not subject to any U.S. formulary minimum taxes.

Such a theoretical splitting of investment income and underwriting income ignores the actuarial assumptions upon which life insurance is based. By failing to take into account the fact that investment income subsidizes underwriting income, any formula which utilizes the worldwide yield of a foreign insurance company to impute investment income to its U.S. operations will produce inflated results where the home country of the foreign insurance company has higher investment yields than the U.S. Because of the highly competitive nature of the financial services industry, higher investment yields dictate higher policyholder benefits. As a result, higher investment yields do not result in higher net profits for the insurance company. Consequently, it is unreasonable to expect that foreign insurance companies with operations in higher interest rate countries should have their worldwide investment yield applied to their U.S. operations without some adjustment for higher levels of policyholder payments. However, if deductions are taken for payments to worldwide policyholders, the result will no longer be worldwide "investment" income. Consequently, the required minimum investment income (calculated based on this adjusted "worldwide yield") will no longer be validly comparable with Actual U.S. Investment Income.

The Subcommittee has concluded that when an insurance company functions in multiple currencies and multiple economies, it is erroneous to assume you can apply a "worldwide current investment yield" to determine U.S. investment income. A numerical example may be helpful in illustrating this point.

Suppose Company C does business only in Canada and Company US does business only in the U.S. Both are of equal size and offer a single product, a deferred annuity contract with interest rates set annually during the deferral period and having sufficient mortality guarantees that the reserves under the contract would be life insurance reserves as defined by the Code. Both companies invest in government T-Bills. Assume Canadian Government 1 Year T-Bills were selling to produce a yield of 5.74%; on the same day, U.S. 1 Year T-Bills were selling to produce a yield of 3.4%.[13] [Note that these interest rates are the actual Canadian and U.S. T-Bill rates published in the Globe and Mail of Toronto, Ontario on June 6, 1993.] Based on these interest rates, and consistent with standard actuarial methodology, contracts would typically be "priced" as follows:

	Company C	Company US
Gross Interest Rate	5.74	3.40
Margin for Investment Expenses	0.20	0.20
Net Investment Yield	5.54	3.20
Administrative Expenses & Contingencies	1.00	1.00
Profit	0.25	0.25
Increase in Benefits Payable to Policyholders	4.29	1.95

The above pricing formula reflects the fact that both companies must be competitive in their own markets with domestic life insurance companies and with other financial institutions. Since Canadian investment yields generally exceed U.S. investment yields,[14] to be competitive in Canada, Canadian multi-national insurers must offer Canadian policyholders market yields which are higher than yields offered to U.S. policyholders. [Note that yields paid to U.S. policyholders must also be market-competitive with yields paid by U.S. banks and insurance companies.] The fact that higher Canadian yields result in higher benefits to policyholders is reflected in the above example: the 2.34% differential in yields (5.74% - 3.40%) results in a 2.34% differential in benefits paid to policyholders (4.29% - 1.95%). Note that, because the competitive nature of the industry requires that competitive yields be paid to policyholders, both companies earn the same profit (0.25) despite the higher Canadian investment yields.

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[13] Historically, spreads between Canadian yields and U.S. yields have been consistently similar to this rate differential. There is an economic correlation between investment yield and the stability of a nation's economy and the economic strength of its currency. Higher investment yields are required in those countries where the currency is regarded as weaker than the U.S. dollar and where the economy is regarded as less economically stable.

If each Company has $100,000,000 of assets and insurance liabilities, based on the pricing formulae above, their income statements would be as follows:

	Company C	Company US
Gross Investment Income	5,740,000	3,400,000
Benefits and Reserve Increase	4,290,000	1,950,000
Expenses - Investment	200,000	200,000
- Other	1,000,000	1,000,000
Profit	250,000	250,000

If Company C were to acquire Company US and merge the two, the "worldwide net investment yield", calculated under Notice 89-96, would be as follows:

$$\frac{5,740,000 + 3,400,000 - 200,000 - 200,000}{100,000,000 + 100,000,000} = 4.37\%$$

Assuming the section 842(b)(4) election was made to use worldwide yield, the U.S. taxable income of the U.S. branch of the merged company (ignoring currency differentials) would be as follows:[15]

Formulary Minimum Investment Income	4,370,000
Non-Investment Expense	1,000,000
Benefits & Reserve Increase	1,950,000
Taxable Income	1,420,000

In the above calculation, taxable income would be approximately **SIX TIMES** the real economic income of the U.S. branch, i.e., $250,000. In addition, U.S. taxable income would be almost **THREE TIMES THE TOTAL WORLDWIDE PROFITS** of the company, i.e., $500,000. This clearly demonstrates that the worldwide yield election does **NOT** eliminate the treaty problem.

As previously alluded to, the fact that the election to use worldwide yield under section 842(b) is not helpful (or even administrable[16]) relates to the role of interest in actuarial calculations and in the actuarial blending process basic to the underwriting operations of a life insurance company. Premium income is invested in income-producing assets and the earnings permit life insurance companies to "discount" premiums in advance in anticipation of such earnings. Premiums are invested while in the company's possession, and it is proper that the resultant interest earnings be regarded as one source of the funds available to pay claims. See Huebner & Black, Life Insurance, 1982, 318. Investment income, in effect, subsidizes underwriting income and is used to pay out underwriting expenses when policyholder claims are made. As noted above, Canadian policyholder benefits are higher because of higher Canadian yields and the requirement to be competitive in the Canadian market.

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[14] Generally, Canadian investment yields closely parallel and almost always exceed U.S. investment yields. See Homer, S. and Sylla, R., A History of Interest Rates, 1991 and 1977, 495; see also Schwartzman, J.B., Forecasting Interest Rates. 1992, 123.

[15] This simplified calculation ignores the minimum surplus ratio requirements. Accordingly, minimum investment income has been calculated as follows:

$100 Million Branch Insurance Liabilities x 4.37% "Worldwide Yield"

Given that Canadian yields consistently exceed U.S. yields, if a Canadian company elects to use worldwide yield, its non-U.S. policyholders will be forced to pay U.S. taxes by virtue of diminished payments to policyholders. Additionally, the insurance company will not be able to price its non-U.S. products competitively because a portion of the non-U.S. investment return will be inappropriately deemed by section 842(b) to be subject to U.S. taxation.

Thus, "worldwide current investment yield" as described in section 842(b)(4) and in Notice 89-96, is not consistent with the actuarial underpinnings of life insurance. To attempt to calculate a net yield, the calculation must adjust in some way for payments to policyholders which are effectively made out of gross investment income. Failure to do so will inflate "investment" yield. But doing so will mean that the result is no longer an "investment yield".

The Subcommittee submits that it is inappropriate to separate investment and underwriting income. An arbitrary separation can be achieved as long as the operations of the company are in a single economic system. But a multinational company must back its policies with investments which match the liabilities in each local currency and market. Under these circumstances, it is extremely unreasonable to require a multinational operation to apply its own worldwide investment yield to determine its U.S. investment income. Accordingly, the election to use worldwide investment yield does **NOT** eliminate the existing treaty violation problem inherent in section 842(b).

VI. CONCLUSION

Section 842(b) is plainly discriminatory. Taxation under section 842(b) as currently drafted represents bad tax policy which should be rectified on a retroactive basis. Retroactive correction is particulary important because of the magnitude of the impact of the 2 year lag in 1988. Since it is unlikely that the drafters intended section 842(b) to tax in such an unfair and discriminatory manner, the correction of section 842(b) should be viewed as a technical correction and should be made retroactive to the date section 842(b) became effective.

June 17, 1993

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[16] Since worldwide assets of foreign insurance companies are not maintained on a U.S. basis, worldwide assets would have to be valued on a U.S. tax basis. In addition, worldwide investment income would also have to be computed on a U.S. tax basis.

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July 7, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
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Washington, D.C. 20515

Dear Ms. Mays:

This office represents Mutual of America which provides actuarial, administrative and investment pension services to not-for-profit social service agencies. Mutual of America was created in 1945 as a tax-exempt retirement association to provide these necessary services to the employees of not-for-profit social service organizations. Over the years, market forces caused Mutual of America to alter its organizational form. In 1979 it became a mutual life insurance company.

The Tax Reform Act of 1986 continued Mutual of America's exemption with respect to its pension business. The continuation of the exemption was in recognition that Mutual of America serves the charitable sector with a broad range of pension services, including investment, but also actuarial and administrative services required in the continuing complex pension environment. These services are generally provided to smaller organizations since a majority of Mutual's customers are charities with fewer than 30 employees whose average annual earnings are less than $30,000.

Over the years Mutual of America has managed its affairs so that it is a financially secure company with the strong ability to deliver on the retirement promises of employers to their employees. In view of the changing economic environment, the Company is studying whether obtaining the ability to access capital in the future, which would be available if Mutual of America were to change its organizational form to that of a stock company, would better enable it to serve these charities and their employees by enhancing and building upon its financial strength.

The proposed clarification before the Subcommittee would permit the continued exemption of the pension business of Mutual of America with a five-year phase out of that exemption if Mutual of America were to revise its present organizational form as contemplated. The proposed amendment would impose a continuing qualification for the phased out exemption, that Mutual of America continue to serve its primarily smaller, charitable clientele. The phase-out is essential to permit an orderly transition to fully taxable status.

Thank you for the opportunity to present this written statement.

Sincerely,

Daniel W. Coyne

DWC:jd

STATEMENT OF

ASSOCIATION OF FINANCIAL GUARANTY INSURERS

On behalf of the Association of Financial Guaranty Insurers, I am pleased to express the Association's support of a proposal to amend section 832(e) of the Internal Revenue Code of 1986, as amended (the "Code"), so as to extend the provisions thereof to certain non-tax-exempt debt securities.

The Association of Financial Guaranty Insurers (AFGI) consists of nine triple-A rated U.S. based companies that insure or reinsure the payment of debt service on municipal, asset-backed and mortgage-backed bonds. AFGI member companies operate solely in the area of financial guaranty insurance. Financial guaranty insurance, commonly called "bond insurance", is an insurance contract that guarantees timely payment of principal and interest when due. The bond insurance contract generally provides that, in the event of a default by an insured issuer, principal and interest will be paid to the bondholder as originally scheduled. The list of AFGI members is attached.

Section 832(e) presently applies to underwriters of mortgage guaranty insurance, lease guaranty insurance, and state and local tax-exempt bond insurance. The proposed amendment expands the scope of section 832(e) to include general financial guaranty insurance. This reflects the fact that the type of insurance which the financial guaranty industry underwrites has expanded from the mortgage insurance offered at the time section 832(e) was first enacted to include other forms of financial obligations. Further, as discussed below, insurance of these other types of financial obligations is subject to the same regulatory and economic restraints which prompted the original enactment of section 832(e). Thus, the proposed amendment constitutes a sensible modification of the Code to reflect new forms of bond insurance, and does so in a way which both Congress and Treasury have previously found acceptable, and, even more importantly, have found not to impose a burden on the federal fisc.

Under section 832(e), a company writing mortgage guaranty insurance, lease guaranty insurance and tax-exempt bond insurance may deduct for federal income tax purposes amounts required by state law to be set aside in a reserve for losses resulting from adverse economic cycles. The deduction cannot exceed the lesser of (i) the company's taxable income or (ii) 50% of the premiums earned on such guaranty contracts during the taxable year. Further, the deduction is available only to the extent that the taxpayer purchases non-interest-bearing "tax and loss bonds" equal to the tax savings attributable to the deduction. The taxpayer insurance company may redeem such bonds only as and when it restores to income the associated deduction for reserves. Reserves are restored to income as and when they are applied, according to state regulations, to cover losses, or to the extent that the company has a net operating loss in some subsequent year. Further, the reserve deduction taken in any particular year must be fully restored to income by the end of the 10th subsequent year. For the tax-exempt bond insurance, this period is increased to 20 years.

Code section 832(e) was originally enacted in January, 1968 (P.L. 90-240), effective January 1, 1967. At that time it applied only to mortgage guaranty insurance. It was enacted in response to high reserve requirements imposed by state regulatory authorities with respect to such insurance. These reserve requirements ranged up to as much as 50% of earned premiums, and amounts were often required to remain in reserve for as long as 10 years. Imposition of a current federal income tax on reserved amounts, [illegible] combined with the effect of [illegible] expenses and a loss experience of approximately 30% of non-reserved premiums, imposed a serious burden on the insurance company's working capital. In such circumstances, the company's federal income tax obligation could easily exceed the cash remaining from available, i.e., unreserved, funds after payment of expenses and losses.

Prior to the enactment of section 832(e), the mortgage insurance industry had relied upon a series of private letter rulings allowing it to treat these contingency reserves as if they were unearned premium reserves, for which a deduction was already permitted. When the Internal Revenue Service revoked these rulings, Congress responded by passing section 832(e), thereby allowing such insurers to take a deduction for such reserves. However, because the reserve requirements imposed by the state regulatory authorities were substantially in excess of that suggested by experience, the legislative history indicates that Congress was concerned that a deferral of tax on such reserves could ultimately result in an unwarranted windfall for the companies. Accordingly, in section 832(e) it required companies to invest the tax savings associated with the deduction in so-called "tax and loss bonds," which are non-interest-bearing obligations issued by the U.S. government. This had the effect of denying the companies the benefit of the earnings on the "float" associated with the tax deferral while at the same time, because the non-interest-bearing bonds were expected to qualify as assets for state financial regulatory purposes, providing relief from the cash flow problems which the insurers would experience if the deduction had not been allowed.

In the years after enactment of section 832(e), the state regulatory authorities applied to lease guaranty insurance and state and local tax-exempt bond insurance the same contingency reserve requirements which they had applied initially to mortgage guaranty insurance. As a result, Congress amended section 832(e) in 1974 (P.L. 93-483) so that it also applied to insurance of those securities as well. The 1974 change was added by means of a floor amendment to P.L. 93-483 offered by Senator Wallace Bennett. Senator Bennett's statement in support of his amendment included a letter from the Treasury Department, in which it said it did not object to the proposal. Significantly, in discussing the provision, Treasury observed that:

> "[f]rom the Treasury's standpoint, the deduction for additions to the special contingency reserve is only temporary, and the non-interest-bearing bonds give the Treasury at all times the unrestricted use of the deferred tax dollars as if there were no deduction and as if taxes were in fact paid." (Emphasis added.)

In short, as Treasury recognized in 1974, assuming tax rates do not change in the period between the issuance of the bonds and their redemption, and because the tax and loss bonds do not bear interest, Treasury's economic position is the same as if no deduction were allowed.

Since 1974, the type of instruments which the financial guaranty industry insures has expanded from the limited types covered then to include general financial obligations. More recently, state regulatory authorities have also decided that the same contingency reserve requirements, which had theretofore been applied only to mortgage, lease guaranty and tax-exempt bond insurance, should also be applied to general financial guaranty insurance. Accordingly, since such financial guaranty insurance is now treated the same as mortgage guaranty, lease guaranty and tax-exempt bond insurance for regulatory purposes, it should also be treated the same for federal income tax purposes and section 832(e) amended accordingly. The same policy concerns which prompted the original enactment of section 832(e) in 1967, and the subsequent expansion of its scope in 1974, are equally applicable here.

For the convenience of Members and staff, suggested wording of the proposed amendment is enclosed. A slightly abridged copy of the letter from the Department of the Treasury expressing its position on the expansion of section 832(e) in 1974 is also attached.

Respectfully submitted,

Association of Financial Guaranty
Insurers

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Reed Smith Shaw & McClay
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(202-457-8626)
Counsel

Association of Financial Guaranty Insurers

List of Members

AMBAC Indemnity Corporation

Capital Guaranty Insurance Company

Capital Markets Assurance Corporation

Capital Reinsurance Company

Connie Lee Insurance Company

Enhance Reinsurance Company

Financial Guaranty Insurance Company

Financial Security Assurance, Inc.

Municipal Bond Investors Assurance Corporation

Proposed Amendment to Section 832(e)
(New language is in italics)

Paragraph (6) of Section 832(e) is amended as follows:

(i) In the title of such paragraph (6), add before the period:

; FINANCIAL GUARANTY INSURANCE

(ii) In the first sentence of such paragraph (6), add before the period:

or a company which writes financial guaranty insurance

(iii) In the second sentence of such paragraph (6), delete the word "and" after the words "lease guaranty insurance," insert a comma in place thereof, and add before the semicolon:

, and to financial guaranty insurance

(iv) In the second sentence of such paragraph (6), after the words "in the case of" add the following:

financial guaranty insurance and

(v) In the second sentence of such paragraph (6), after the words "revenues related to" add the following:

such financial guaranty or

After such amendment, Paragraph (6) of Section 832(e) would read as follows:

> (6) LEASE GUARANTY INSURANCE; INSURANCE OF STATE AND LOCAL OBLIGATIONS; *FINANCIAL GUARANTY INSURANCE.* --In the case of any taxable year beginning after December 31, 1970, the provisions of this subsection shall also apply in all respects to a company which writes lease guaranty insurance or insurance on obligations the interest on which is excludable from gross income under section 103 *or a company which writes financial guaranty insurance.* In applying this subsection to such a company, any reference to mortgage guaranty insurance contained in this subsection shall be deemed to be a reference also to lease guaranty insurance, to insurance on obligations the interest on which is excludable from gross income under section 103, *and to financial guaranty insurance;* and in the case of *financial guaranty insurance and* insurance on obligations the interest on which is excludable from gross income under section 103, the references in paragraph (1) to "losses resulting from adverse economic cycles" include losses from declining revenues related *to such financial guaranty or* to such obligations (as well as losses resulting from adverse economic cycles), and the time specified in subparagraph (A) of paragraph (5) shall be the twentieth preceding taxable year.

Letter from the Department of the Treasury regarding the 1974 Amendment to Code section 832(e)

(Retyped and abridged from version printed in the Congressional Record, August 13, 1974, p. S 14854)

Department of the Treasury,
Washington, D.C.
March 25, 1974
Hon. Wilbur D. Mills, Chairman
Committee on Ways and Means,
House of Representatives, Washington, D.C.

Dear Mr. Chairman:

. . . This bill would allow those insurance companies which are writing lease guarantee insurance and insurance guaranteeing the debt service of municipal bond issues (i.e., obligations the interest on which is excludable from gross income under Section 103 of the Code) to deduct additions to contingency reserves in accordance with the current treatment of such additions for mortgage guaranty insurance under Section 832(e).

Mortgage guaranty insurance companies guarantee the holder of a real estate mortgage against loss on a mortgage loan. State insurance commissions regulate these insurers by requiring the establishment of a contingency loss reserve of up to 50 percent of earned premiums in order to protect against extraordinary losses resulting from adverse economic cycles. These reserve additions are not related to loss experience and remain in the reserve for 15 years, in the absence of authorization from the State commission for prior restoration of income. Normal losses are charged to income currently, rather than to the reserve. Prior to enactment of Section 832(e), the deductibility of additions to a contingency loss reserve was in dispute. Where state law requires 50 percent of earned premiums to be placed in a reserve for extraordinary losses, it would be extremely difficult, if no deduction were allowed for such reserve additions, for a company to operate without continuing additions to working capital, since current losses and other expenses amount to more than 50 percent of their earned premiums.

Section 832(e) was intended to deal with these unusual State law requirements and to afford uniform treatment to all companies engaged in writing mortgage guaranty insurance. . . .

The net tax effect to a mortgage guarantee insurance company under Section 832(e) is the ability to carry back for as much as 10 years extraordinary losses from such insurance against taxable income. The deduction for additions to the special contingency reserve gives no immediate tax benefit, since that "benefit" must be invested in tax-and-loss bonds. A non-tax benefit is gained, however, since the bonds are recognized by both accountants and state insurance commissions as assets for financial statement purposes and may thus be used for the special contingency reserve.

Similarly, from the Treasury's standpoint, the deduction for additions to the special contingency reserve is only temporary, and the noninterest bearing bonds give the Treasury at all times the unrestricted use of the deferred tax dollars as if there were no deduction and as if taxes were in fact paid currently. Although the insurance companies obtain a deduction for additions to the special reserves over the approximate average life of the mortgages guaranteed (10 years), at the same time the companies are denied the earnings on the portion of such reserves representing deferred taxes during the time that portion is held for special contingencies.

Lease guarantee insurance and insurance on tax-exempt obligations have generally been subject to the same contingency reserve requirements as mortgage guarantee insurance. Accordingly, the reasons for enactment of Section 832(e) for mortgage guarantee insurance companies are equally applicable to those companies writing lease guarantee insurance and/or insurance on tax-exempt obligations.

The Treasury Department does not object to the enactment of H.R. 4520, but calls the Committee's attention to the fact that the legislation would be generally effective with respect to all taxable years beginning after December 31, 1970. In addition, because of the provisions of Section 832(e)(1)(B), a deduction would be allowed in the current taxable year for additions to a contingency reserve for taxable years beginning after January 1, 1967, but before January 1, 1971. While the Treasury Department normally opposes retroactive legislation, it recognizes that there are unusual circumstances in this case which the committee may wish to consider.

. . .

It is not possible to quantify the revenue effect of this bill, but its effect is thought to be negligible.

The Office of Management and Budget has indicated that it has no objection from the standpoint of the Administration's program to the submission of this report.

Sincerely yours,

Frederic W. Hickman
Assistant Secretary.

STATEMENT ON BEHALF OF
COLONIAL LIFE & ACCIDENT INSURANCE COMPANY
CONCERNING PROPOSED AMENDMENT TO IRC SEC. 848

I. Introduction

My name is Jean E. Duke and I am Vice President of Finance and Treasurer of Colonial Life & Accident Insurance Company (hereinafter referred to as "Colonial"), a life insurance company operating in 49 states and the principal subsidiary of the holding company, Colonial Companies, Inc.

This statement is presented on behalf of Colonial in connection with the September 1993 hearings by the Subcommittee on Select Revenue Measures, Committee on Ways and Means, on miscellaneous revenue issues. Specifically, we are providing comments with regards to the proposed amendment to reduce the amount of policy acquisition costs that are required to be amortized by life insurance companies selling "employer-sponsored"[1] (payroll marketed) noncancelable or guaranteed renewable individual accident and health insurance policies by applying the same capitalization rate applicable to group life insurance under IRC Section 848.

The early development of § 848 involved the identification of different categories of life, health and annuity insurance, based upon product characteristics such as levels of acquisition costs and lapse rates. This generally resulted in a 120-month straight line amortization scheme with varying premium capitalization rates to reflect differences between lines of business. We believe that the writers of § 848 inadvertently overlooked a distinct, identifiable category of insurance: employer-sponsored noncancelable or guaranteed renewable individual accident and health insurance. Although included with "other life" in § 848(c)(1)(C), Colonial's employer-sponsored accident and health products have characteristics which are significantly different from that of individual ordinary life products sold through traditional marketing channels. This is due to major differences in acquisition costs and lapse rates, which are the basis of the § 848 "proxy" system. In fact, the product characteristics of Colonial's employer-sponsored accident and health business more closely align to the product characteristics of group life insurance. How Colonial's employer-sponsored accident and health product characteristics compare to that of individual and group life products, as well as the reasons for differences or similarities are further explained in Section V below.

We are aware that the provisions of § 848, which provided for varying capitalization rates based upon line of business and one amortization scheme, were intended to serve as a "proxy" for the industry primarily for administrative reasons. It is our understanding that as a result of this proxy, no company should be significantly negatively or positively impacted. Based upon the analyses we have performed, it is our belief that we have fallen outside of these "reasonable" boundaries. Colonial's negative impact from § 848 is nearly twice that of the life insurance industry. The negative impact on Colonial's surplus is more than four times than that of the life insurance industry. We do not believe that Congress intended for a handful of companies to be inequitably treated to this extent within one capitalization category.

II. Nature of Colonial's accident and health insurance business

Colonial is the leader in payroll marketed, voluntary benefit programs and products which are designed to meet the needs of both employers and employees in the management of their benefits and compensation costs. The term "payroll marketing" is used by Colonial to describe sales made by Colonial's representatives to employees at their place of work which includes small business and governmental organizations, among others. Approximately 96 percent of Colonial's total premiums for 1992 were received from insurance written through payroll marketing. Premiums collected on a direct individual pay and group basis comprise the remaining 4 percent.

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[1] An "**employer-sponsored**" noncancelable or guaranteed renewable accident and health contract is defined by Colonial to mean any noncancelable or guaranteed renewable accident and health insurance contract (a) issued to an employer, a group of employers, or an employee of an employer, covering the employee and/or the employee's spouse and/or dependents, (b) where premiums are remitted to the insurance company by the employer in accordance with a written agreement between the employer and the insurance company, whereby the employer either pays premiums on behalf of the employee or withholds premiums from the pay of the employee, and (c) whose benefits are paid either to the employee or at the assignment of the employee and not to the employer or for the benefit of the employer.

Colonial's major product line is payroll marketed guaranteed renewable accident and health insurance which accounted for approximately 88 percent of the premiums received by Colonial during 1992. Individual life and group life insurance premiums comprise the remaining 12 percent. Many of Colonial's accident and sickness policies are sold to complement other insurance benefits to which the insured may be entitled. The predominant accident benefit offered is short-term disability income, packaged with other indemnity or specific loss coverages which offer payments for specific injuries such as fractures, dismemberment, and accidental death. With the basic accident plans, sickness coverage for hospital indemnity, or hospital indemnity plus disability income, can be added. Colonial's cancer insurance program emphasizes "wellness" or diagnostic benefits; additional benefits include hospital room and board, surgery, radiation and chemotherapy.

III. Discussion of why section 848 impacts Colonial more than other life companies

There are several factors contributing to the fact that § 848 has a more severe impact on Colonial than other life insurance companies:

(1) Colonial's business is predominantly employer-sponsored individual accident and health insurance, rather than ordinary individual life insurance. This type of business is very different from individual life insurance. With respect to lapse rates and acquisition costs, it is more like group life insurance.

(2) The accident and health policies sold by Colonial are overwhelmingly guaranteed renewable. Thus, over 96 percent of Colonial's premiums are included in the 7.7 percent capitalization rate category under § 848. The remaining 4 percent is comprised of group life, group accident and health and annuities.

(3) Colonial cannot easily increase premiums on existing or new accident and health business to adjust for the "DAC" tax (i.e., the taxes paid under § 848). The reasons for this fact are as follows:

- (a) On existing business, Colonial would have to file for rate increases in all 49 states in which Colonial does business. Requests for rate increases based solely upon an increase in expenses, such as the increased taxes paid under section 848, will generally not be approved. Approvals for rate increases are generally only given by state regulators based upon adverse claims experience. In contrast, on existing business, life insurance companies can make adjustments on participating business through changes in policyholder dividend rates or through changes in credited interest rates on policies with nonguaranteed elements.
- (b) On new business, a significant portion of Colonial's business is represented by policyholders within existing employer groups. If Colonial filed a new policy form with higher rates for the new policyholders within an existing employer group, then two or more rates would be created for that one employer. This is not desirable either from Colonial's perspective or the employer's perspective. In contrast, a life insurance company can easily adjust premiums on new business for most participating or nonparticipating ordinary individual life insurance.

IV. Categories of insurance contracts under section 848

Section 848 provides that insurance companies must capitalize specified policy acquisition expenses. In lieu of identifying each item of expense that relates to the acquisition or renewal of an insurance contract and amortizing this expense over the life of the contract, which Congress noted is the "theoretically correct approach"[2], section 848 requires that a company capitalize an amount of otherwise deductible expenses equal to a certain percentage of net premiums for each of several broad categories of insurance contracts. This capitalized amount is generally amortized over a period of 120 months.

The different capitalization rates for each of the three categories identified in § 848(c)(1) are intended to reflect the differences in insurance product characteristics, specifically relating to levels of acquisition costs and lapse rates, or persistency. Presumably, because a higher capitalization rate applies, those specified insurance contracts included in the other life 7.7 percent category (§ 848(c)(1)(C)) should generally have higher levels of acquisition costs and lower lapse rates or higher persistency than the specified insurance contracts included in the group life 2.05 percent category.

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[2] Committee Reports, '90 OBRA, P.L. 101-508, 11/5/90.

While this "proxy" system of § 848 is simpler to administer than a theoretically correct "actual" approach, the "rough justice" in the application of this system produces inequity for insurance companies who sell employer-sponsored noncancelable or guaranteed renewable individual accident and health insurance products, which are grouped with individual life insurance products in the highest capitalization rate category of 7.7 percent (as discussed in Section V below).

V. Comparing employer-sponsored accident and health products to group life and individual life products

Although included in the 7.7 percent capitalization rate category because the policies are guaranteed renewable, Colonial's employer-sponsored accident and health insurance business is significantly different from ordinary individual life insurance business when comparing lapse rates and acquisition costs. Employer-sponsored accident and health insurance products are marketed and underwritten like group insurance, and the acquisition costs and persistency characteristics more closely resemble group life insurance as compared to fully underwritten individual life insurance, the predominant line of business in the 7.7 percent other life category.

Major differences in acquisition costs (as a percentage of first-year premiums) between group life, ordinary individual life and employer-sponsored accident and health insurance are as follows[3]:

(1) Group life acquisition expenses are generally much lower than individual ordinary life due to relatively level group commissions, overall lower commission rates and lower underwriting costs (i.e., policy records are maintained at the group level and agent solicitation expenses are lower).

(2) Employer-sponsored accident and health insurance acquisition expenses are less than half of individual ordinary life due to (a) lower first-year commissions, (b) lower selling expenses, and (c) simplified underwriting. Colonial underwrites all employer-sponsored accident and health coverages on a simplified issue basis. Simplified underwriting results in lower acquisition costs for Colonial due to the fact that no medical exams are required to obtain insurance coverage. Simplified issue underwriting also results in a very low rejection rate for policy applications, which effectively reduces underwriting costs and thus, reduces Colonial's overall level of acquisition expenses. For accident-only coverages which comprise approximately 61 percent of Colonial's accident and health insurance business, there is no health underwriting.

(3) Acquisition expenses are generally higher for employer-sponsored accident and health insurance as compared to group life insurance due to the following factors: (a) individual records are maintained for Colonial's employer-sponsored accident and health insurance business, and (b) selling expenses are higher for employer-sponsored accident and health insurance because the agent spends time with each employee to explain the insurance benefits, in contrast to group sales. However, this difference is more than offset because average premium lapse rates for group life are about one-half the average premium lapse rates for employer-sponsored accident and health insurance.

Persistency is typically measured differently for group life insurance as compared to employer-sponsored accident and health or individual ordinary life insurance. However, we believe that comparing lapse rates and average policy life from industry data and company experience is an appropriate means of measuring the differences in the length of time that policies stay in force for group life, ordinary individual life and employer-sponsored accident and health insurance.

Based upon actual premium lapse rates from industry studies for ordinary individual life insurance[4], actual premium lapse rates from company experience studies of employer-sponsored accident and health insurance[5], and average lapse rates from group life insurance industry studies[6], we determined that the average length of time that policies stay in force for each line of business were as follows: (a) 13.5 years average life for ordinary individual life; (b) 9.1 years average life for group life; and (c) 4.2 years average life for employer-sponsored accident and health products.

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[3] Based upon available industry data and company experience studies.

[4] LIMRA Lapse Survey on Long-term Ordinary Life (1992); reference: page 4, Table E.

[5] From Colonial Life & Accident Insurance Company experience studies on lapse rates.

Colonial's employer-sponsored accident and health products have lower persistency (i.e., higher lapse rates) when comparing to ordinary individual life and group life insurance due to the following factors:

(1) Colonial's employer-sponsored accident and health products generally do not persist as well as traditional life or other longer-term coverages sold through traditional marketing channels. A major factor affecting Colonial's persistency experience is the effect of employee turnover (i.e., terminations, relocation, attrition, etc.), which may result in discontinuance of elected insurance coverage by the employee, disregarding the fact that the policies may be continued at the employee's election. Also, Colonial's primary markets are small to medium-sized employers, who are known to have higher employee turnover rates in contrast to large employers.

2) Colonial's employer-sponsored accident and health products do not persist as well as group life products, when comparing average premium lapse rates. The primary reason for this fact is that within a group for a group life contract, individual policyholders may lapse coverages while new policyholders come into the group and obtain new coverages (i.e., there is a constant flow of individual policies in and out of a group which is covered by the insurance company at the group level); therefore, the number of employees will not significantly change over the life of the group life policy and the average premium lapsing remains fairly level.

(3) In contrast to individual and group life policies, Colonial's employer-sponsored accident and health products are generally designed to provide immediate protection over a specified period of time. Colonial's policies provide benefit payments for short-term disability income, death, dismemberment, major injury and indemnity payments for hospitalization and medical benefits. These benefits typically meet shorter term benefit planning needs as contrasted to a traditional life or group life insurance policy which meets longer term benefit planning needs.

Models developed by Colonial, which compare the relationships between lines of business under both an "actual" capitalization and amortization system (i.e., where actual acquisition costs and actual lapse rates are used) and the "proxy" 10-year system of § 848, demonstrate that the 7.7 percent capitalization rate is clearly inappropriate for employer-sponsored individual accident and health products which have predominantly group characteristics. In fact, these analyses show it is far more appropriate for these products to be included in the group life category where premiums are capitalized at 2.05 percent.

VI. Impact of section 848 on Colonial's results

The additional taxes under section 848, or the DAC tax, has a significant impact on the results of Colonial, particularly as compared to life insurance industry results. Compared to the pre-1990 tax laws, Colonial's cumulative taxes on gain from operations in the two-year period from January 1, 1991, through December 31, 1992, increased 93 percent as compared to estimated industry averages of 42 to 45 percent[7]. Colonial's income taxes are roughly 50 to 60 percent of the company's statutory income due to the DAC tax, while the industry's income taxes are approximately 35 to 40 percent of statutory income. The impact of § 848 on Colonial's surplus (9 percent) is far greater than industry averages (2 percent[8]). Earnings retention has been significantly impacted, which virtually eliminates Colonial's ability to grow surplus for policyholder protection. We project that by the end of 1995, Colonial's capital and surplus will have been reduced by 29 percent solely due to the DAC tax.

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[6] LIMRA Group Life and Health Lapse Survey (1992); reference: page 4.

[7] Industry data obtained from studies performed by Chalke, Inc. and from A.M. Best.

[8] Based upon industry data obtained from studies performed by Chalke, Inc.

VII. Conclusion

Section 848 clearly penalizes insurance companies which specialize in the sale of employer-sponsored individual accident and health products which, as a direct benefit to the consumer, are guaranteed renewable. Therefore, we recommend that the proposed amendment to subject employer-sponsored accident and health contracts to the same § 848 capitalization rate as group life insurance, or 2.05 percent, be adopted to achieve the original intent of the "rough justice" system of § 848 as applied to this line of business.

Attachment: Proposed Amendment to § 848

Proposed AMENDMENT to IRC. Section 848: Attachment 1

(To subject employer-sponsored noncancelable or guaranteed renewable accident and health insurance to the same DAC proxy rate as group life insurance)

In IRC. Sec. 848:

Amend subsection (c)(1)(B) to read:

(B) 2.05 percent of the net premiums for such taxable year on specified insurance contracts which are group life insurance contracts or employer-sponsored noncancelable or guaranteed renewable accident and health insurance contracts, and

Amend subsection (e) to add new paragraph (3) as follows:

(3) The term "employer-sponsored noncancelable or guaranteed renewable accident and health contract" means any noncancelable or guaranteed renewable accident and health insurance contract--

(A) issued to an employer, a group of employers, or an employee of an employer, covering the employee and/or the employee's spouse and/or dependents,

(B) where premiums are remitted to the insurance company by the employer in accordance with a written agreement between the employer and the insurance company, whereby the employer either pays premiums on behalf of the employee or withholds premiums from the pay of the employee, and

(C) whose benefits are paid either to the employee or at the assignment of the employee and not to the employer or for the benefit of the employer.

Amend (e) to renumber current sections (3), (4), and (5) as (4), (5) and (6).

This amendment is to be effective for the first tax year of the taxpayer starting after December 31, 1993.

Note: Underlined sections represent new language added to IRC Sec. 848.

TESTIMONY BY THE TAX SECTION OF THE FLORIDA BAR BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, HOUSE WAYS AND MEANS COMMITTEE

JUNE 22, 1993 HEARINGS

COMMENTS ON SUBCHAPTER S PROPOSALS

By Jerald David August*

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* Member of the Directors' Committee of the Tax Section of the Florida Bar; Last-Retiring Chair, Committee on S Corporations, Tax Section of the American Bar Association; Editor-in-Chief, Journal of S Corporation Taxation, Warren Gorham & Lamont, New York, New York.

The Tax Section of the Florida Bar ("Tax Section") welcomes the opportunity to submit the following comments as part of the hearings conducted by this Subcommittee on miscellaneous tax proposals under consideration by the House Ways and Means Committee. The following comments are with respect to the proposals affecting the eligibility rules under Subchapter S of the Internal Revenue Code ("Code").[1]

INTRODUCTION

The Subchapter S proposals before this Subcommittee would broaden the eligibility rules governing Subchapter S corporations and their shareholders. The effect of such liberalizations, especially in the areas of shareholder identity and capital structure, would enhance the ability of S corporations to compete for available sources of venture capital as well as conventional financing for funding business operations. Although there are policy and practical benefits involved in removing certain eligibility limitations under Subchapter S reflected in the proposals, the Tax Section recognizes that the subject of Subchapter S reform may be part of the debate concerning the integration of corporate and shareholder level taxation. More specifically, there may be concern on whether it is appropriate at this time to widen the eligibility net under Subchapter S, in light of the Treasury's recent study on corporate integration.[2] Although much praise has been given to the complete or pure integration model descriptive of the pass-through rules under Subchapter S,[3] the Treasury does not embrace Subchapter S as the proper method to achieve integration.[4]

In addition to the debate over integration of corporate and shareholder level taxes, we are further mindful of the budget and tax policy debates which are currently before the Congress and acknowledge that even well-intended and conceptually sound reforms to Subchapter S must still run the gauntlet of assessing their impact on the budget deficit. Subject to these concerns, the Tax Section endorses the set of proposals before this Subcommittee to improve Subchapter S and believes such reforms would be well-received by the small business community and its tax advisors.

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[1] Such proposals are described on pages 30 through 39 by the Joint Committee on Taxation Staff, reprinted in Daily Tax Report (BNA), June 17, 1993, at L-1.

[2] See Treasury Dep't, Report on Integration of the Individual and Corporate Tax Systems: Taxing Business Income Once (1992); letter from Nicholas F. Brady, Secretary of the Treasury, to The Honorable Dan Rostenkowski, Chairman of the House Comm. on Ways and Means (Dec. 11, 1992), reprinted in Daily Tax Report (BNA), Dec. 14, 1992, at L-7. ALI, Federal Income Tax Project, Integration of the Individual and Corporate Income Taxes, Reporter's Study on Corporate Tax Integration (March, 1993).

[3] See Ginsburg, "Maintaining Subchapter S in an Integrated Tax World", 47 Tax L. Rev. 665 (1992); McNulty, "Commentary, Preserving the Virtues of Subchapter S in an Integrated World", 47 Tax L. Rev. 681 (1992).

[4] In the short term, Treasury recommends the use of a dividend exclusion prototype, whereby the incidence of tax would fall at the corporate level based on corporate tax rates. The dividend exclusion approach achieves a level of partial integration since it only addresses distributed earnings. The Treasury Report further proposed a 10-year phase in of a comprehensive business income tax or CBIT as the proper model for complete integration. Under CBIT, income would be taxed at the entity level with respect to all business enterprises, incorporated or unincorporated. Distributions allocable to previously taxed income would be received tax-free. No deduction would be permitted with respect to dividends or interest paid by the entity. Recognizing that the CBIT entity level model and Subchapter S shareholder allocation model are in conflict, Treasury would recommend the repeal of Subchapter S were the CBIT adopted by Congress. See Treasury Report, note 2.

NEED FOR BROADENING THE ELIGIBILITY RULES UNDER SUBCHAPTER S

When Subchapter S was enacted into law by Congress in 1958, it was designed to permit owners of certain closely-held businesses organized as corporations to achieve limited liability as well as other favorable corporate characteristics under state law, while at the same time avoiding a double tax on distributed earnings under Subchapter C. The objective was not only the avoidance of double taxation, but also to permit owners of S corporations to report corporate losses on their individual returns.[5]

Remedial legislation followed in 1982 when it was determined that the rules governing distributions and losses were overly complex and often became traps for the unwary.[6] SSRA's expressed aim was for shareholders in an S corporation to achieve tax treatment comparable to partners in partnerships. Such legislation included repeal of the prior concept of a retroactive termination of S status, the adoption of more streamlined pass-through, basis adjustment and distribution rules, and partial relief for S corporations deriving significant levels of passive investment income. Despite the substantial revisions made to Subchapter S in 1982, the legislation left unchanged the basic set of shareholder and corporate level eligibility rules, including the one class of stock limitation.

In recent years there has been much debate over the purpose or purposes served by retaining the present set of corporate and shareholder eligibility rules. Critics have voiced that certain shareholder and corporate level limitations no longer serve any valid tax policy.[7] Prohibitions such as the one class of stock rule and the rule prohibiting ownership of subsidiaries represent substantial impediments to conducting business operations under Subchapter S form and thereby contravene the Congressional purpose behind its enactment.

The present set of shareholder eligibility rules limit the types as well as number of shareholders permitted to own S stock. The rule limiting the number of permitted shareholders was presumably enacted to prevent administrative problems in allocating profits to more than a small group of investors.[8] The prohibition against corporate or partnership shareholders was to prevent the circumvention of the number of shareholders limitation.

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[5] S. Rep. No. 1983, 85th Cong., 2d Sess. 87, reprinted in 1958-3 C.B. 922, 1008.

[6] The Subchapter S Revision Act of 1982 ("SSRA"), Pub. L. No. 97-354, 96 Stat. 1669, reprinted in 1982-2 C.B. 702. At the core of the SSRA legislation was the repeal of the complex, multi-tiered distribution rules governing undistributed taxable income and previously taxed income as well as the repeal of the prior rule preventing the carryover under Subchapter S of losses in excess of basis.

[7] Eustice, "Subchapter S Corporations and Partnerships: A Search for the Pass Through Paradigm", 39 Tax L. Rev. 345 (1984).

[8] See Richard B. Goode, The Postwar Corporation Tax Structure (Treasury Department 1946), reprinted in Eustice and Kuntz, "Federal Income Taxation of S Corporations", Warren, Gorham & Lamont, (New York, NY, 1985), Appendix ¶ B.1.

Based on counting problems and administrative concerns over income allocation issues for varying equity interests, it would appear that the original design of the eligibility limitations under Subchapter S was, for want of a better phrase, "keep it simple" or "plain vanilla." Thus, an S corporation could not have a corporate, partnership or tax-exempt shareholder. Similarly, a non-U.S. individual could not own S stock. The rules also limited the types of trusts which could own stock in an S corporation.

After 35 years of Subchapter S, it is time that these limitations be reassessed, especially in light of current business realities and demands. Not only do the shareholder eligibility rules deny certain potential investors access into Subchapter S, but further cause anxiety on the part of the shareholders and their advisers to maintain constant vigilance to ensure that no transfer of stock is made to an ineligible shareholder. Loss of the S election results in a substantial tax cost to the shareholders, requires a 5 year waiting period for re-entry, and upon re-entry, a 10 year phase out of double taxation under the built-in gains tax provision. In contrast, no investor eligibility limitations are imposed on other pass-through entities such as partnerships or limited liability companies ("LLC"). As long as the criteria to avoid status as an "association" is proscribed in the operating agreement and charter provisions, the tax status of a partnership or LLC as a pass through entity is not jeopardized.[9]

In addition to the shareholder eligibility limitations, an S corporation is not permitted to own more than 79% of the stock of another corporation, which by definition, must be a C corporation. This precludes a group of S corporations under common ownership from organizing a holding company to achieve limited liability on a subsidiary-by-subsidiary basis and the operational and administrative efficiencies of a consolidated group structure. No such limitation prevents a partnership from owning controlling interests in one or more lower tiered partnerships or corporations.

The one class of stock limitation similarly restricts the use of Subchapter S. S corporations can only issue a single class of equity to its investors although differences in voting rights are permitted. From a practical standpoint, concern over a violation of the one class of stock rule, with its concomitant loss of S status, frequently impairs owners of an S corporation from obtaining conventional forms of business financing. If a single class of equity requirement under Subchapter S may be defended on grounds of administrative convenience, it is difficult to understand why a similar limitation is not imposed under Subchapter K. Partnerships and LLCs have absolute flexibility to issue preferred interests to their investors.

Faced with these obstacles, and with the repeal of favorable rules governing the liquidation of corporations as part of the 1986 Tax Reform legislation,[10] the growth in the use of limited partnerships, and the recently discovered LLC, has led to a substantial erosion in the use of Subchapter S.[11] This is because limited partnerships and LLCs enjoy all the benefits afforded a pass-through entity for federal income tax purposes while suffering none of the detriments under Subchapter S. From a critical perspective, were current trends to continue, Subchapter S would be relegated only to those corporations eligible to convert from Subchapter C to S status, but are precluded from liquidating and reorganizing under partnership or LLC format due to prohibitive tax and transactional costs.[12]

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[9] Treas. Reg. §§ 301.7701-2(associations), -3(partnerships).

[10] P.L. 99-514, § 631(a) (1986).

[11] See August, "Editor's Comment: The Limited Liability Company - The "Super Pass-Through Entity?", 4 J. S Corp. Tax'n, p.199 (Winter, 1993).

The Tax Section applauds this Subcommittee and the Ways and Means Committee for taking up the issue of liberalizing the eligibility rules under Subchapter S. Not only are such reforms long overdue, but passage would reverse the sharp decline in the selection of Subchapter S as a preferred entity for conducting business operations.

PROPOSALS TO MODIFY THE ONE CLASS OF STOCK RULE

One area in which reform is needed is the one class of stock rule found in Code section 1361(b)(1)(D), which requires that all stock (and, under the regulations, rights to acquire stock) be identical with respect to rights to receive distributions.[13] The regulations provide that with respect to the issuance of debt, if such instrument constitutes equity under general tax principles, and, has as one of its principal purposes, the circumvention of the one class of stock or other eligibility limitations under Subchapter S, then such debt will be treated as a prohibited second class of stock.[14]

In order to avoid a termination of the S election on account of disguised debt, section 1361(c)(5) describes a "straight debt" safe harbor. Only an individual who is eligible to be a shareholder in an S corporation can hold "straight debt." Moreover, straight debt may not, by definition, be convertible into stock or provide for interest payments which are "contingent on profits, the borrower's discretion, or similar factors."[15]

The narrow definition of "straight debt" viewed in conjunction with the amorphous circumvention test for evaluating hybrid or participating debt under the regulations,[16] prevents owners of S corporations from seeking forms of venture capital financing that are commonplace in the market. This not only places owners of S corporations at a competitive disadvantage in obtaining such funds, but has an indirect effect of rewarding only the most sophisticated of S corporation shareholders, who, after obtaining the advises of tax counsel or other experts, can structure a participating or hybrid loan arrangement without the adverse tax risk of forfeiting Subchapter S status.

Accordingly, the Tax Section endorses the proposals before this Subcommittee which would expand the definition of straight debt under Code section 1361(c)(5)(B) to include debt held by creditors other than individuals. The definition of straight debt, however, should also include debt held by any lender regularly engaged in the business of loaning funds, regardless of the specific loan terms governing interest or conversion rights. This is a preferred method for resolving the convertibility issue under the straight debt safe harbor rather than by generally permitting convertibility, per se, as is stated as a separate proposal before this Subcommittee. In fact, where a person other than one regularly engaged in the business of financing receives convertible debt, the Tax Section believes there is a potential second class of stock issue which should be resolved in accordance with the existing regulations.[17]

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[12] Still, corporations converting from C to S status face a 10-year period for double taxation on prior years' unrealized income items and asset appreciation under the built-in gains tax in IRC § 1374.

[13] Differences in voting rights and under certain forms of buy-sell, redemption or employment agreements are permitted. IRC § 1361(c)(4). Treas. Reg. § 1.1361-1(l).

[14] Treas. Reg. § 1.1361-1(l)(4)(ii).

[15] IRC § 1361(c)(5)(B). Treas. Reg, § 1.1361-1(l)(5).

[16] _See_ note 14.

In addition to expanding the definition of straight debt as a buffer to the one class of stock limitation, Congress should give serious consideration to permitting S corporations to issue a limited class of preferred stock. The inability of investors in an S corporation to receive a priority distribution of profits or priority return of risk capital has been a major disadvantage of Subchapter S especially when viewed in comparison with limited partnerships or LLCs. Many small business enterprises consist of family members who are involved either as capital and/or service providers. As far as a capital provider is concerned, such individual, who may be a grandparent or parent of the active service provider, has a legitimate interest in receiving a return on and priority repayment of her risk capital. Under Subchapter S, such result cannot presently be achieved unless the service provider is willing to initially forego a stock interest until the capital provider has been completely repaid her risk capital, or unless the capital provider is issued straight debt, which may detrimentally affect the ability of the corporation to seek outside financing.

The Tax Section endorses the proposal to permit the issuance of preferred stock but only to individuals who would otherwise be eligible to own stock in an S corporation. The features of the preferred should include cumulative and noncumulative dividend payment rights, but must otherwise be nonconvertible and nonparticipating. No income, deduction or loss from S corporation operations would be allocable to the holder of the preferred. Instead, any dividend paid to the preferred shareholder would be includible in gross income in the year received and deductible by the corporation in the same year. Such rules would make the use of preferred stock easy to administer and do not create assignment of income issues not already present when analyzing the issuance of insider debt or multiple classes of equity interests permitted under Subchapter K.

PROPOSALS AFFECTING THE USE OF TRUSTS AND SUBCHAPTER S

A common problem which confronts S corporations owned by family members are the rules prohibiting discretionary or complex trusts from owning stock in an S corporation. This is particularly problematic for multi-generational family ownership of an S corporation. Limited relief is available under present law in the form of the qualified Subchapter S trust ("QSST") provision, contained in Code section 1361(d).

Despite the availability of the QSST rules, many shareholders in S corporations have their testamentary instruments prepared by lawyers who may only be vaguely familiar with Subchapter S or are not aware of the exact nature of each investment made by his or her client. Such counsel may similarly be unaware of the specific rules under Subchapter S as to the types of trusts which are eligible to own S stock as well as the elective mechanics under the QSST provisions. Often the problem of an ineligible trust is unknown until a particular shareholder dies and the beneficiaries of such person's estate are first informed of the drafting problem and its adverse impact to all shareholders of the corporation. Moreover, the QSST rules, which prohibit the use of an accumulation trust, are often inconsistent with the estate planning objectives of a client whose wealth may be concentrated in ownership of stock in one or more S corporations.

In addressing this problem area, there are several proposals concerning trusts on which this Subcommittee will hear testimony.

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[17] _See_ Treas. Reg. § 1.1361-1(l)(4)(iii)(B).

One proposal would allow stock in an S corporation to be held by an "electing small business trust" ("ESBT"), as defined. The qualified Subchapter S trust or QSST rule would be retained but could not be an ESBT. A special entity level tax regime would be imposed on the ESBT but only with respect to its ownership of stock in one or more S corporations. Taxes would be imposed at the maximum rate of tax imposed on individuals. Distributions from the ESBT would not be taxable to the beneficiaries and losses, including capital losses, would not pass through.[18] Otherwise, Subchapter J would apply with respect to the other assets of the ESBT.

An alternative proposal is to permit discretionary trusts involving multiple income beneficiaries to own stock in an S corporation. Each income beneficiary would be treated as a shareholder. The general rules under Subchapter J would govern the taxation of the multiple income beneficiary trust ("MIBT"). It is unclear whether the QSST rule would be retained.

Although amendments to Subchapter S adopting either the ESBT or MIBT approach would mark an improvement over current law, the Tax Section endorses the MIBT. Such would not only serve the interests of Subchapter S, but would avoid the complexity of grappling with a new or hybrid form of trust for federal income tax purposes under the ESBT regime.[19] The rules under Subchapter J easily adapt to those situations in which a trust owns one or more interests in a pass through entity, such as another trust or partnership. Accordingly, there is no need, at least from a conceptual standpoint, to create a new taxing regime on Subchapters S and J under the ESBT rules. Although the ESBT model strongly resembles the CBIT integration model suggested by the Treasury, the Tax Section believes that the adoption of the ESBT rule is misplaced, at least at this time. The ESBT rules will not only increase the administrative costs and burdens associated with administering a trust owning S stock, since trustees and their advisors will have to simultaneously grapple with the tax rules under Subchapter S, Subchapter J, and the new ESBT rules, but will also trigger new and complex fiduciary accounting questions which may need special remedial legislation under each state's applicable principal and income act.

In summary, in the interests of simplicity, the Tax Section strongly favors the adoption of the MIBT proposal over the ESBT proposal.

OTHER PROPOSALS MODIFYING THE SHAREHOLDER LIMITATION RULES

In order to remove further competitive disadvantages suffered by shareholders of S corporations, the Tax Section endorses the four proposals before this Subcommittee under the caption "Shareholder limitations for S corporations." Two of these suggested reforms include removing the restrictions on issuing S stock to tax exempt organizations and nonresident aliens.

As to the tax-exempt organization eligibility question, current law prohibits a charity from receiving a gift of S stock. This restriction frequently defeats the charitable desires of shareholders of S corporations without any compelling policy reason for its existence. Similarly, owners of an S corporation may not organize an employee stock ownership plan for its employees. Such prohibition also appears to lack a legitimate tax policy objective.

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[18] It should be noticed that the ESBT resembles the CBIT model endorsed by the Treasury in its integration study. See note 4, supra.

[19] Furthermore, under the MIBT approach, the present QSST rules could be repealed.

For these reasons the proposal to permit tax-exempt organizations to be eligible shareholders should be adopted by Congress.

The prohibition on issuing stock to nonresident aliens is also outmoded, given the fact that a system for withholding has been designed and implemented with respect to nonresident aliens holding interests in domestic partnerships or partnerships doing business within the United States.[20] Moreover, repeal of the non-resident alien limitation would eliminate consideration of whether this rule violates nondiscrimination provisions under bilateral income tax conventions.[21]

There are several proposals which would increase the number of permitted shareholders. First, the proposed increase from 35 to 50 is a welcome reform, although an increase to any number is somewhat arbitrary. Since the generally held belief is that most S corporations are owned by 5 or fewer individuals, such change in the number of shareholders may generally prove to be somewhat academic except where ownership is concentrated in one or more families having multi-generation shareholders. Thus, what is more essential than the proposal to increase the number of permitted shareholders from 35 to 50, are the proposals treating all shareholders of the same family (within 4 generations) as one shareholder or otherwise adopting a family attribution rule similar to that contained in Code section 267. Present law, which lacks such an attribution rule for counting purposes other than with respect to spouses, poses an obstacle to maintaining ownership of stock in an S corporation once one or more of the first generation members of a family owned S corporation have died. The problem is most visible with respect to multiple income beneficiary trusts, whereby each vested and contingent income beneficiary will be counted as one shareholder absent a family attribution rule.

Accordingly, the Tax Section endorses the proposal which would treat all family members as one shareholder under rules similar to those presently contained in Code section 267(c)(4).

PROPOSAL PERMITTING S CORPORATIONS TO HOLD SUBSIDIARIES

Under current law, a group of S corporations under common control is not permitted to form a holding company and attendant consolidated group structure. Instead, such group must operate as separate brother-sister affiliates. This is because an S corporation must own less than 80% of the stock of another corporation.[22]

In most instances, the need to maintain separate corporations is dictated by asset protection concerns. This is particularly true with respect to environmentally sensitive businesses and operations that are heavily leveraged. Regular or C corporations may consolidate to achieve desired asset and liability protection objectives while at the same time availing themselves of the tax advantages provided under the consolidated reporting rules under section 1504 and the regulations issued thereunder. Partnerships and LLCs are similarly permitted to own tiers of partnerships, LLC subsidiaries, or stock ownership in a consolidated group of companies.

No policy is served by prohibiting an S corporation from owning any percentage of stock in a C corporation. Accordingly, we endorse the proposal before this Subcommittee to permit such ownership, accepting that consolidated reporting would be prohibited, except for tiers forming below the first tier C subsidiary.[23] Although downstream transfers of assets to a C subsidiary would generally qualify for nonrecognition treatment, upstream distributions to the parent presumably will generally be subject to taxation in accordance with Code sections 311 and 301. Thus, since shareholders of the parent-S corporation will bear a double-tax cost when a C subsidiary sells or distributes appreciated assets, the tax benefits of this proposal may be marginal, i.e., S corporations acquiring a consolidated group of C corporations where future business operations will be conducted within the consolidated group.

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[20] IRC §§ 1445, 1446.

[21] See O.E.C.D. Model Treaty, Article 24 (1977); U.S. Model Treaty, Article 24 (1977).

[22] IRC § 1361(b)(2)(A). In many instances ownership of all the shares of stock of a subsidiary is achieved by the shareholders acquiring the remaining (21% or more) of the stock not owned directly by the S corporation.

The Tax Section further endorses the proposal which would allow an S corporation to own 100% of the stock of a chain of S corporation subsidiaries. Again, if consolidated reporting is not permitted, distributions by S subsidiaries of appreciated property will be taxable up through the group to the shareholders of the parent S corporation. Distributions of depreciated property presumably will not be permitted to generate deductible losses and may also create corresponding basis problems.

Despite the strong organizational preference to allow 100% ownership of a chain of S corporations, it is recognized that the ownership of an S subsidiary raises additional issues that would need to be resolved. The problems are generated by concerns over whether intercompany transfers between a group of S corporations can be designed to avoid the special corporate level taxes under Subchapter S with respect to one or more subsidiaries. Present law would permit the issuance of regulations to address potential abuses in this area.[24] Additional complexity may present itself with respect to resolving basis and pass through issues, similar to the investment basis rules under the consolidated return regulations. Consideration should also be given, however, to permit intercompany transactions to be subject to the same deferral concepts available under the consolidated return regulations.

The operational and liability protection benefits of allowing 100% ownership of a chain of S corporations, without sacrificing pass through treatment for federal income tax purposes, would vastly improve Subchapter S. Although further refinements and technical analysis is required under this proposal, the Tax Section believes that given that partnerships and LLCs may adopt tiered structures, any difficulties present with respect to ownership of a chain of S corporations are capable of resolution and should not override the underlying policy objective.

CONCLUSION

Needed reform to the eligibility rules will not only provide greater investor access to Subchapter S, but will permit S corporations to compete for sources of financing and equity on a more equal footing with other tax forms of business enterprises, including other pass through entities. When such reforms are coupled with the technical corrections legislation presently before Congress that would specifically authorize S corporations to engage in certain forms of acquisitive transactions under Subchapter C, the passage of both sets of reforms would greatly enhance the viability of Subchapter S as a preferred ownership vehicle for small business.[25]

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[23] Such proposal is contained in § 603(c) of H.R.13, the Tax Simplification Bill of 1993.

[24] IRC §§ 337(d). Proposed Reg. § 1.1374-9.

[25] It is recognized that certain proposals to Subchapter S have already been approved by the tax-writing committees of Congress and are reflected in the set of tax simplification provisions again before Congress this term. See H.R. 13, §§ 601-603.

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STATEMENT OF

LAWRENCE C. UPDIKE
SECRETARY
ALCOMA ASSOCIATION, INC.

BEFORE THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

This statement is in support of H.R. 2439, Congressman Shaw's bill to allow family-owned Subchapter S corporations to have more than thirty-five shareholders if each of the shareholders is a family member. The proposal is described in Select Revenue Measures press release #4, under the heading Pass-Through Entities, Item #2.

Our company -- Alcoma Association, Inc. (Alcoma) -- illustrates why Mr. Shaw's proposal deserves immediate attention. Alcoma and its related entity, Alcoma Packing Company, Inc. (also an "S" corporation) are citrus growing and processing companies, which are based in Lake Wales, Florida. Alcoma was founded in 1941 by Archibald Updike and his financial backers. After World War II, Mr. Updike began to actively involve his two sons and his one son-in-law in Alcoma's operations. Despite freezes, hurricanes, and a disastrous fire, Alcoma survived and, in the late 1950s the Updike family began to buy out non-family shareholders. That buy-out was completed in the late 1960s.

Over the ensuing years, Alcoma has been strictly a family business. Not only were Archibald Updike's children (and their spouses) made shareholders but his eleven grandchildren and eighteen of his thirty-six great grandchildren have become shareholders as well. However, under current law, Subchapter S corporations can have only thirty-five shareholders. Thus, only three of the remaining eighteen great grandchildren can become shareholders if Alcoma is to retain Subchapter S status. Thus, absent adoption of Mr. Shaw's proposal, the Updike family will be forced to either leave fifteen grandchildren out of the family business or fragment that business to allow them to participate on an equal basis with their cousins.

The family owners of Alcoma, like many other families adversely affected by the thirty-five shareholder limit, believe that continued family ownership of businesses should be encouraged. Proposals like that of Congressman Shaw will make that possible.

STATEMENT ON BEHALF OF SOLO CUP COMPANY IN SUPPORT OF EXCEPTION TO 35-SHAREHOLDER LIMIT FOR FAMILY-OWNED S CORPORATIONS

Hearings on Miscellaneous Revenue Issues
Subcommittee on Select Revenue Measures
House Ways and Means Committee
June 22, 1993

Chairman Rangel and Members of the Subcommittee:

Solo Cup Company greatly appreciates your willingness to consider the proposal contained in H.R. 2439 to create an exception to the S Corporation 35-shareholder limitation for family-owned corporations. In addition, Solo Cup Company would like to commend Mr. Shaw for introducing H.R. 2439 and for so vigorously working for its passage.

FACTS ABOUT SOLO

Solo Cup Company is an Illinois-based company. Solo was founded in 1936 as a manufacturer and distributor of paper cups. Over the years, the company has expanded its offering of paper products and, in the early 1970s, began producing disposable plastic cups and related plastic products. Today Solo is one of the leading suppliers to the consumer market and food service industries in the Unites States. Solo presently employs 3,600 people in the U.S. and has facilities in 14 states and Puerto Rico, and 2 in Canada.

Solo is presently an S Corporation. Under current law, S Corporations can have no more than 35 shareholders.

HISTORY AND EFFECTS OF THE 35-SHAREHOLDER LIMITATION

The current 35-shareholder limit has evolved since the adoption of Subchapter S. Originally, Subchapter S could only be availed of by corporations with 10 or fewer shareholders. The shareholder limit was increased to 15 in 1976 for certain corporations and was extended to 15 for all S corporations in 1978. The limit was expanded to 25 in 1981, and, finally, the rule was revised again in 1982 when the current 35-shareholder limit was enacted. Throughout this time period, the purpose of the numerical shareholder limit has always been to limit the benefits under Subchapter S (no tax at the corporate level) to closely-held businesses while ensuring that large, widely-held corporations remain subject to the classical system of two levels of tax.

While the purpose of the 35-shareholder limit is sound, the limit can have the unintended effect of making it difficult for a family to retain ownership of their business within the family. As many small business owners age, they seek to transfer some of their shares to their descendants. However, families with a reasonably high number of children and grandchildren face a dilemma because of the 35-shareholder rule.

A simple example illustrates the problem. Assume that all of the shares of X Corporation (an S Corporation) are owned equally by three siblings, A, B and C. A, B and C each have three children, and each of the children has three children of their own. If A, B and C want to give their X Corporation stock to each of their children and grandchildren, the business would no longer qualify as an S Corporation: there would be 39 shareholders!

Of course, A,B and C are not required to give shares to all their grandchildren; they could each leave the shares only to their children or only to the children and some, but not all, of the grandchildren. But this approach creates problems of its own. Grandparents generally seek to equalize the gifts and bequests they make to their grandchildren. If some grandchildren do not receive S Corporation stock, the grandparents will need a sufficient amount of other assets in order to equalize the value of property being transferred to each grandchild. Otherwise, their non-tax-motivated estate plan would be thwarted.

Thus, the 35-shareholder limit creates a dilemma for the family-owned S Corporation. The owners must choose one of three approaches:

(1) Continue operating the business as an S Corporation at the cost of being unable to leave property equally to all their grandchildren;

(2) Sacrifice the company's S Corporation status in order to achieve their estate planning goal; or

(3) Sell the company.

From the perspective of good tax policy, it is unclear why this decision if forced on the owners of the S Corporation. All they seek is to leave property to their children and grandchildren in equal amounts. Essentially, they are penalized for having too large a family.

It is universally acknowledged that the 35 shareholder limit is an arbitrary line. While clear boundaries are necessary for good tax administration, they should not be so rigid that owners of S Corporation shares are forced to choose which of their grandchildren will not receive stock in the family business in order to maintain their S Corporation status. Surely the tax code ought not compel family-owned businesses to forego their S election merely to keep the business ownership in the family.

Instead, Subchapter S should be designed to foster family ownership of businesses. The tax laws should not be configured in a way that forces families to choose between losing their company's S status and keeping the business within the family in accordance with their legitimate, non-tax motivated estate planning objectives.

SUPPORT FOR H.R. 2439

H.R. 2439, introduced by Mr. Shaw, would create an exception to the 35-shareholder rule for family-owned businesses. In particular, the exception would exclude a family-held corporation from the 35-shareholder limit where all the shares of the corporation are owned by lineal descendants (or their spouses or former spouses) of a common ancestor. A business would qualify for S status no matter how many shareholders it had so long as all of its shareholders were family members.

The bill defines "common ancestor" as an individual who is no more than four generations removed from the youngest generation of shareholders at the time the S election is made or when the provision becomes effective, whichever is earlier. This insures that corporations could not trace their common ancestor all the way back to Adam and Eve (which would arguably make every corporation eligible for S status). At the same time, it insures that a corporation need only qualify once under this exception so long as all shareholders of the corporation are family members.

Other proposals have been made that would allow corporations owned by large families to retain their S Corporation status. In particular, it has been suggested that "families" be treated as one shareholder for purposes of the 35-shareholder limitation. Such an "attribution" approach would be acceptable to Solo. However, the attribution approach has been criticized by some as moving too far away from the limited ownership requirements currently embodied in Subchapter S. Unlike H.R. 2439, an attribution approach would extend the benefits of Subchapter S to a corporation owned by 35 families of unlimited size. For example, a corporation owned by 35 families of 50 individuals each could, under the attribution approach, qualify for S status even though it had 1,750 shareholders. H.R. 2439, on the other hand, does not permit this "multiplier" effect. H.R. 2439 is much more limited and only creates a one-family exception to the 35-shareholder limitation.

CONCLUSION

At a time when small businesses are responsible for creating the majority of new jobs in this country, the tax rules should not penalize families that seek to maintain ownership of their business in the family. The family-business exception would make it easier for the owners of a family-owned corporation to keep ownership of the business within the family without having to contend with the 35-shareholder limit. As a result, family ownership could be maintained in a manner that preserves the integrity and original purpose of the 35-shareholder rule. Creating an exception to the 35-shareholder rule for family-held businesses thus makes sense from a tax policy standpoint and would help ensure that these small businesses continue to grow and prosper.

Thank you, Mr. Chairman and members of the Subcommittee.

STATEMENT ON BEHALF OF WELLS MANUFACTURING COMPANY IN SUPPORT OF PROPOSAL TO PERMIT OWNERSHIP OF S CORPORATION SHARES BY ELECTING DISCRETIONARY TRUSTS

Hearings on Miscellaneous Revenue Issues
Subcommittee on Select Revenue Measures
House Ways and Means Committee
June 22, 1993

Chairman Rangel and Members of the Subcommittee:

Wells Manufacturing Company greatly appreciates your willingness to consider the proposal to allow discretionary trusts to be S Corporation shareholders. In addition, Wells Manufacturing would like to commend Mr. Neal for his support of this proposal.

FACTS ABOUT WELLS MANUFACTURING

Wells Manufacturing is an Illinois-based corporation that was founded in 1946. The company employs approximately 750 people in Illinois, Indiana and California. The company manufactures iron castings and bars, and has annual sales of approximately $83 million.

Wells Manufacturing is not an S Corporation at this time. The company is presently unable to make an S election because current law limits the ability of certain trusts to own S Corporation stock. The company envisions making an S election if the proposal under discussion is enacted.

CURRENT LAW

Under current law, only certain types of trusts are permitted to hold shares in an S Corporation. In particular, both grantor trusts and qualified Subchapter S trusts (QSSTs) are allowed to hold S Corporation shares. In addition to other requirements, a QSST cannot have more than one current income beneficiary at a time.

As a result, a corporation will not qualify as an S Corporation under current law if its shares are owned by a discretionary (or "spray") trust. A spray trust is one in which the trustee is given discretion to distribute income between some number (greater than one) of potential beneficiaries or to retain the income in the trust.

USE OF SPRAY TRUSTS IN ESTATE PLANNING

Spray trusts are valuable estate planning devices. They allow assets of the estate to be consolidated in one trust for the benefit of multiple beneficiaries as opposed to dividing the estate into specific shares for each beneficiary (most often, the surviving spouse, children and grandchildren). Rather than multiple trust arrangements (with their attendant duplication in administrative costs), the trustee is given discretion to distribute income or principal to the beneficiaries depending upon their needs. Generally, the trustee also has discretion to accumulate income in the trust. This type of arrangement maximizes flexibility, enhances investment potential (by consolidating all the estate assets in one trust), and minimizes administrative costs. It is easy to see why spray trusts are often the planning tool of choice.

The current law prohibition on spray trusts holding S Corporation stock often results in multiple trusts being created instead. Owners of S Corporation stock will not sacrifice their company's S status merely to take advantage of spray trusts; instead, the shareholders will create multiple trusts, one or more for each beneficiary. While this technique accomplishes their estate planning goals, it does so at the cost of increased trust administration fees and complexity. All for the sake of non-tax motivated goals.

EXPLANATION OF PROPOSED AMENDMENT

The proposal of Mr. Neal would permit spray trusts to be S Corporation shareholders under certain conditions. These limitations are designed to eliminate possible abuses that might otherwise occur if discretionary trusts could hold S Corporation stock.

First, only individuals who are U.S. citizens or residents could be potential current beneficiaries. This is consistent with current S Corporation rules governing individual shareholders. Second, each potential current beneficiary would count as one shareholder. This would insure that the current 35-shareholder limit could not be circumvented by using a spray trust.

Finally, and most importantly, all the income of the trust would be taxed to the trust at the highest individual tax rate. The individual beneficiaries receiving distributions of income would not, themselves, be taxed. This limitation would eliminate the potential ability of the trustee to distribute income among beneficiaries in a way that minimizes the overall income tax liability on the trust's income.

Therefore, these limitations eliminate any potential abuses that could occur if spray trusts were permitted to hold S Corporation stock. At the same time, these limitations also eliminate any reason to prohibit discretionary trusts from holding S Corporation stock.

Of course, not everyone will choose to use spray trusts. These rules will often result in higher income taxes than if separate trusts were used. Those that value the tax savings over the flexibility of a spray trust will likely forego use of a spray trust in favor of a multiple trust arrangement. On the other hand, those whose planning goals are not tax motivated will likely opt for the flexibility and administrative cost savings that spray trusts can provide.

It is conceivable that the proposal would actually raise revenue over current law. For example, an electing trust would still be required to pay tax at the highest individual rate even though the trustee eventually distributes income to some beneficiaries who fall within lower tax brackets. This would even be the case with respect to a trust where all of the beneficiaries were in lower tax brackets.

This provision was included in the Senate version of last year's H.R. 11 as part of the package of simplification proposals. Although it is not clear why the provision was dropped from the conference agreement, it is clear that the provision would result in significant simplification of Subchapter S.

CONCLUSION

This proposal would enhance the ability of individuals to plan their estates as they see fit in a manner consistent with the tax policy principles of Subchapter S. Wells Manufacturing urges the Subcommittee to approve its enactment.

Thank you, Mr. Chairman, and members of the Subcommittee.

STATEMENT
on
CHANGES TO THE S CORPORATION TAXATION RULES
for submission to the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
of the
HOUSE WAYS AND MEANS COMMITTEE
in its hearings on
MISCELLANEOUS REVENUE ISSUES
by
Dennis B. Griffin
President, Griffin Industries, Inc.
July 24, 1993

Griffin Industries, Inc. is pleased to provide comments on possible changes to the provisions governing S Corporations, specifically with reference to the limitations on shareholders, the limitations on corporate structure, and the limitations on entities which may invest in or own stock in S Corporations. Griffin urges Congress to amend these rules in order to provide more flexibility in these areas so that family-owned corporations, such as Griffin, which are actively growing and creating jobs in the U.S. may continue to grow while maintaining their S Corporation status. Griffin supports legislation which would provide for additional flexibility with respect to qualified shareholders and investors in S Corporations including an increased number of shareholders or the aggregation of family units treated as a single shareholder, provisions to allow utilization of more sophisticated financial instruments in the ownership structure of S Corporations, and provisions to allow S Corporations to have subsidiaries. Griffin believes that, as currently structured, the rules surrounding S Corporation qualification and operation are overly restrictive and impact the ability of S Corporations to continue to grow while maintaining their family ownership structure. Griffin also believes that increased flexibility would allow S Corporations more efficient access to capital markets and greater ability to continue to grow.

Griffin Industries, Inc. is a 50 year-old family-owned business operating in the rendering industry throughout the Southeastern United States. The company has 15 plants located in 11 states and employs 830 people. The company's primary businesses are the recycling of solid animal waste by-product from slaughtering operations and the recycling of used grease from the restaurant industry into salable components for animal feeds, fertilizers and other organic products.

Griffin was established in 1943 as the Griffin Fertilizer Company by John L. Griffin and his wife, Rosellen. The company began operations with a single truck in the rural regions of Northern Kentucky. Since 1943, the company has grown through diligence and hard work and today represents a significant economic force in the Northern Kentucky areas and in the rendering industry as a whole. Today, the company is owned, managed, and operated by the children and grandchildren of John L. Griffin and has grown, both internally and through acquisition, utilizing the provisions of subchapter S. Although its S Corporation status has provided benefits and opportunities to the corporation, as the company has grown and expanded, it has found these provisions to increasingly restrict its ability to grow and expand. Specifically, the company faces the inability to bring additional family members or even non-family members into its shareholder group since it currently is at the maximum level permitted under law. In addition to preventing additional family members from participating in ownership of the company, the current limitation on ownership will prevent us from being able to offer an ownership interest to employees and will limit our access to additional capital.

Over the past several years, Griffin has been actively interested in creating new businesses and new opportunities within its corporate structure. Although a number of approaches have been pursued and a number of opportunities reviewed, the restriction on both the types of capital available and the ownership structure available (*i.e.*, single class of common stock and no subsidiaries) has severely hampered these efforts and has, on more than one occasion, led to an inability to go forward.

Griffin believes that additional financing alternatives would be available to it if it were able to approach venture capital groups utilizing capital forms such as preferred stock and participating debt. This would open significant other sources of capital to this growing and expanding business not currently available under the restrictive requirements of the S Corporation status. The availability of this additional capital should create further expansion opportunities and, thus, the ability to create additional products, operations, and jobs.

Further, Griffin is interested in pursuing new markets and in the creation of new products, both domestically and overseas. Frequently, businesses find the entry into new markets or product lines have significant risks and problems associated with the expansion opportunity and find it of strong benefit to be able to put these new operations into separate corporate entities. Major corporations frequently use a parent and multi-tiered subsidiary structure in order to be able to segregate these new operations appropriately while maintaining control in a central location for the businesses on an overall basis. S Corporations are currently precluded from owning 80 percent or more of the stock of a subsidiary. This limitation on an ownership structure which is readily available to many of Griffin's competitors makes it more difficult not only for the company to expand but also for the company to compete in the marketplace.

Griffin believes it could be a more significant center of economic activity and better able to compete in the marketplace if these types of structures and sources of capital were made available to it. Although Griffin has grown over the years, there is a continuing and growing concern that the limitations presented to this family business will ultimately lead to the business going out of the family and the family going out of the business. Griffin believes that tax rules which drive a family business away from family ownership represent bad economic policy as well as bad tax policy. Given the large amount of jobs created in the least decade by businesses such as Griffin Industries and the lack of significant tax policy justifications for the limitations placed on S Corporations, we believe it would be good economic policy, good tax policy, and good social policy to promote rules which would facilitate growth in this significant economic segment. We know from experience that the changes which we support here would, indeed, lead to increased growth and increased opportunity via the S Corporation/family business ownership route.

We appreciate the opportunity to provide our views on this topic to this Committee. We urge Congress and this Committee to increase the flexibility allowed for S Corporations in order to facilitate the ability of these U.S taxpayers to compete in their markets and to continue their growth and job creation. We would be pleased to provide additional information should it be necessary or helpful.

Testimony
of
KENNETH M. NOVACK
before
The Ways and Means Committee
United States House of Representatives
June 22, 1993

Mr. Chairman and Members of the Committee:

Thank you for the opportunity to present testimony on the issue of Subchapter S Corporations. First, I want to commend you, and the Committee, for your fine work in crafting new Subchapter S legislation in last year's bill, H.R. 11, which was vetoed by President Bush. This Committee must make many hard decisions which affect the lives of every American and I admire your courage and tenacity as you move forward with tax legislation this year. The Committee has a fine new member in Congressman Kopetski from my state, Oregon. He has been a great addition to our congressional delegation and his hard work, intelligence and integrity will serve the Ways and Means Committee well.

I am the President of Schnitzer Investment Corporation, which is part of a group of business interests owned by several generations of the Schnitzer family in Portland, Oregon. Schnitzer Investment Corporation traces its origins to the formation of Schnitzer Steel Products Company in the 1930's, which was formed to engage in the scrap iron and steel business. Schnitzer Investment Corporation, a real estate development and management business, was founded by the four Schnitzer brothers. Our company's real estate division has investments in office buildings, industrial parks, and apartments -- primarily in the Portland, Oregon; Seattle, Washington; and, San Francisco, California metropolitan areas. The industrial operations are comprised of several million square feet of industrial, office, and warehouse space at various locations. Both Schnitzer Steel and Schnitzer Investment Corporation, as well as our Seattle Cold Storage Division, have grown into successful operations today, and continue to be owned and operated by members of my family. My family also has investments in both United States flag and foreign flag shipping businesses, and retail, industrial and real estate operations on the island of Guam.

Although not large by Wall Street standards, our company represents a true American success story, and a major investment and source of income for my family. The three surviving brothers now range in age from 69 to 86 years.

Our company elected to be taxed as an S Corporation for federal income tax purposes as of September 2, 1988. The founders and their spouses together own 34% of the outstanding stock of our company. Over the years, they have transferred stock ownership representing 54% to their 13 children, and 12% to 16 of their 23 grandchildren.

Under current United States income tax rules, an S Corporation is required to have no more than 35 shareholders. At the present time, Schnitzer Investment Corporation has a total of 33 shareholders. My family wishes to continue to provide stock ownership opportunities to all family members. Under current tax law, however, it is precluded from doing so.

The 13 children of the second generation presently range in age from 26 to 55 years. Four of those are active in management of the business. The 23 grandchildren currently range in age from nine months to 34 years old. All but three are under age 25.

Obviously, the first and second generations are hopeful that several of the grandchildren will, in the future, take active roles in the business. The older generations believe that providing the opportunity for significant stock ownership to all members of the younger generation is the most important aspect of developing an interest in the business. Developing such interest will become critical to the survival of our company as a Schnitzer family owned and operated business in the decades to come. Continuation of S Corporation status for income tax purposes clearly provides the most efficient way to have this business continue to grow and prosper.

I understand that the 35-shareholder limit is intended to ensure that the benefits of S status are limited to closely held businesses and not extended to large, widely held companies. My family is not alone in wanting to keep ownership of their business in the family. The limit puts us and many other businesses across the country in the difficult position of choosing between losing the benefits of S status, selling a portion or all of the business, or not leaving shares to some of the descendants. Each of these choices is undesirable and they achieve no tax policy benefit. The importance of family-owned businesses to this country should not be underestimated. At a time when small businesses are responsible for creating most of the jobs in this country, tax policy should not penalize families who want to keep ownership of the business in the family.

There are several ways to solve the 35-shareholder limit. Last year, thanks to the work of the Ways and Means Committee and yourself, Mr. Chairman, Congress approved H.R. 11 which included a provision to raise the Subchapter S shareholder limit from 35 to 50. This legislation, however, was vetoed by President Bush. This approach would certainly solve my family's immediate problem and the problem for other family businesses.

There may also be a broader and more permanent solution. I understand that Representative Shaw may propose a bill providing an exception to the 35-shareholder limit. This exception would apply where all the shares are owned by descendants (or their spouses) of a common ancestor. Businesses would qualify for S status no matter how many shareholders they had so long as all the shareholders were family members. On the other hand, the corporation could have no outside shareholders. Family ownership would thus be preserved while the integrity and original purpose of the 35-shareholder rule would remain in tact. This solution would provide a permanent remedy for the enlarged, third and fourth generation family situation. The Schnitzer family enthusiastically supports this approach and would strongly urge the Committee to consider this proposal as you prepare new tax legislation.

In closing, I would like to thank you, Mr. Chairman, and the Committee, for the opportunity to appear before you to discuss a matter of importance to my family and to family businesses across the nation.

Arkansas Electric
Cooperative Corporation

P. O. Box 194208
Little Rock, Arkansas 72219-4208
(501) 570-2200

July 21, 1993

The Honorable Charles Rangel
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
1105 Longworth House Building
Washington, D.C. 20515

Dear Mr Chairman:

The Arkansas Electric Cooperative Corporation would like to voice its strong support for the testimony of Mr. Bob Bergland, Executive Vice President of the National Rural Electric Cooperative Association, in favor of Congressman Brewster's proposal to clarify the tax treatment of safe harbor leasing by generation and transmission rural electric cooperatives.

We believe that, by providing the electric cooperative with a specific statutory exemption from the repeal of safe harbor leasing, Congress made an unequivocal statement that they intend to preserve the tax benefits of safe harbor leasing for the cooperatives. The Internal Revenue Service's position in a number of audits has had the effect of retroactively overruling the intent of Congress on this important economic issue for rural America. Mr Brewster's bill is a well thought-out compromise which preserves both the interests of the government and the millions of rural electric ratepayers serviced by the electric cooperatives.

On the behalf the members of our cooperatives, we urge the Subcommittee to favorably report out Mr. Brewster's bill to the full committee. This clarification could save the government and the cooperatives years of costly litigation and appeals. Thank you for your time and consideration.

Sincerely,

Carl S Whillock
Carl S. Whillock
President/CEO

STATEMENT OF BOB BERGLAND, EXECUTIVE VICE PRESIDENT NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION

Mr. Chairman, distinguished members of the Subcommittee, my name is Bob Bergland and I am executive vice president of the National Rural Electric Cooperative Association (NRECA). I submit this statement for the hearing record on behalf of the nation's approximately 1,000 not-for-profit, consumer-owned rural electric systems that provide central station electric service to more than 25 million people in 46 states.

Rural electric lines span 70 percent of the nation's land mass to serve 10 percent of the nation's population. These rural electric systems continue to face the traditional obstacles that make serving rural areas difficult — rugged terrain, harsh weather and distance.

On behalf of the members of NRECA, I thank the subcommittee for scheduling hearings on miscellaneous revenue items and appreciate the opportunity to comment on one item in particular: the proposal to permit the interest income and rental expense with respect to safe harbor lease transactions of rural electric cooperatives to be netted and to allocate the difference between members and nonmembers in proportion to the business done with each, as supported by Representative Bill Brewster of Oklahoma.

NRECA wholeheartedly endorses this proposal put forward by Representative Brewster and urges the Subcommittee and the full Ways and Means Committee to include it in any tax bill in which miscellaneous revenue provisions are included. The members of NRECA extend their thanks and appreciation to Representative Brewster for his support of this proposal.

TAX-BENEFIT TRANSFERS

A provision included in the Economic Recovery Tax Act of 1981 (ERTA) allowed companies to sell capital assets for tax purposes while retaining the use and legal ownership of the assets. A purchaser bought tax benefits associated with the capital asset including the then-existent investment tax credits and accelerated depreciation. This tax benefit transfer transaction was structured as a sale-leaseback and was known as a "safe harbor lease" because it was, for tax purposes, treated as a true lease.

In the typical safe harbor lease transaction, a seller "sells" a capital asset for an up-front payment plus a promissory note payable in equal periodic installments over a set term, about 20 to 30 years in the case of assets "sold" by rural electric cooperatives. The buyer immediately "leases" the asset back to the seller for a term equal to the term of the promissory note. The periodic rental payment on the lease exactly equals and offsets the periodic payment on the promissory note, so after the up-front payment, no additional cash between the buyer and seller is exchanged. In order to qualify as a safe harbor lease, specific requirements had to be met by both parties to the transaction.

Safe harbor leases were phased out by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). While available, however, safe harbor leases helped several struggling companies including U.S. Steel, Chrysler Corporation, major airlines, and 14 rural electric generation and transmission cooperatives. By significantly lowering these companies' costs of capital, new and more efficient facilities were made more affordable.

RURAL ELECTRIC SYSTEMS: A UNIQUE CORPORATE STRUCTURE

Rural electric cooperatives are utilities distinguished by their form of corporate organization and their commitment to the people of rural America to whom they provide power. The cooperatives are owned by those who buy electricity from them (their members), controlled democratically by locally elected boards of directors, and operated at cost such that no profit is generated for outside investors. A cooperative's margins, which are generated by members through the payment of electric bills, are returned to those same members based on the amount of electricity they purchase. Until returned to members, the margins form the cooperative's primary base of capital.

Beginning in the 1940s and much accelerated in the 1960s, rural electric distribution cooperatives began to band together to gain better access to wholesale electricity markets and to take advantage of economies of scale inherent in the electric utility industry. The cooperatives formed generation and transmission cooperatives (G&Ts) which are essentially cooperatives whose members are not individual persons but the distribution cooperatives themselves. The G&Ts are separate corporate entities from their members and subject to the same cooperative principles outlined above. They were organized to purchase power on the wholesale electricity market or to own generating plants and/or transmission lines to provide and carry electricity to member rural electric distribution systems.

The relationship between a G&T and its members is both contractual and membership-based. The G&T has contracts with its members to sell them power. It also acts on behalf of its members in securing the lowest-possible cost reliable supply of electricity.

RURAL ELECTRIC COOPERATIVES AND SAFE HARBOR LEASES

As a result of projected load growth in the late 1970s and continuing into the 1980s, rural electric systems across the country decided to begin building baseload power plants, peaking power plants and associated transmission facilities.

Fourteen G&T systems, following the cooperative principle of operating at the lowest possible cost to their members consistent with prudent business practices, undertook safe harbor leases during the early 1980s. All of the G&Ts which executed safe harbor lease transactions did so because the leases reduced the heavy impact on wholesale rates of new, large capital assets such as power plants and transmission facilities.

In order to execute the safe harbor leases, some of the G&Ts gave up a long-standing tax exemption, reasoning that the tax benefits were not of great value to organizations which, by definition operate on a not-for-profit basis, while the sizable up-front payment from a safe harbor lease would help ease costly power plants into their rate bases.

Most, if not all, of the G&Ts sought a private letter ruling from the Internal Revenue Service (IRS) during the process of executing the lease transactions. Thus, the IRS was well aware that rural electric G&T cooperatives were entering safe harbor lease transactions. Nevertheless, the IRS failed to issue regulations for safe harbor leases on member/nonmember allocations of those leases required under Section 277 of the Internal Revenue Code of 1986 (Code) for membership organizations.

COOPERATIVE ACCOUNTING AND SAFE HARBOR LEASES

Taxable G&Ts, like other taxable cooperatives, must separate revenues and deductions between member operations and nonmember operations. Section 277 of the Code, which generally applies to taxable membership organizations, limits deductions associated with serving members to the amount of income received from the members. Any amount of member deductions in excess of member income (i.e., net member losses) may not be used to offset current or future years' nonmember net income. Thus, pursuant to Section 277, taxable membership organizations must allocate every revenue item and tax deduction between member operations and nonmember operations. Income tax must always be paid on nonmember net income, without regard to member net losses.

Member/nonmember categorization of revenues and deductions can be problematic. Many items of tax deduction, for example, might be incurred primarily for the benefit of members, but also provide some benefit to nonmember operations. Should member/nonmember allocation of such deductions be done on the basis of marginal cost to nonmembers, or average cost on some allocation base, for example, sales to members versus nonmembers? The IRS has published no final regulations or guidelines on how taxable membership organizations should allocate revenues and deductions between member and nonmember operations pursuant to Section 277 which was enacted as a part of the Tax Reform Act of 1969. A regulation, pursuant to Section 277, was proposed in 1972 which provided "[i]tems of deduction attributable in part to nonmembership activities and in part to membership activities shall be allocated between the two classes of activities on a reasonable and consistently applied basis." This proposed regulation, however, was withdrawn without explanation in the mid-1980's. Thus, taxpayer must decide on segregation and allocation methods which seem reasonable in the circumstances and then hope that the IRS will agree with them in any later audit.

Lacking IRS regulations to the contrary, nearly all of the fourteen G&Ts which executed safe harbor leases considered the entire safe harbor lease transaction to be a part of nonmember operations. This logical determination, which was made by these G&Ts based on advice from their respective tax counsel and/or accountants, reflects the fact that the safe harbor lease transaction (i.e., the sale-leaseback) is between the cooperative and a nonmember. Accordingly, the interest income from the safe harbor promissory notes they hold and the safe harbor rent expense pursuant to the lease were shown on tax returns as nonmember items. This revenue item and deduction item largely offset one another when matched.

In 1985, an IRS revenue agent challenged the G&T allocation methodology for the safe harbor lease of a power plant in an audit of Western Farmers Electric Cooperative of Anadarko, Oklahoma (WFEC). The IRS agent agreed that WFEC should consider the interest income from the promissory note as nonmember revenue, but held that the rent under the leaseback of the power plant should be divided between member and nonmember operations based on the member and nonmember usage of the leased asset.

Because WFEC's power plant which was the subject of the safe harbor lease was built and is being used primarily to meet member load requirements, the IRS agent's allocation methodology would force WFEC to record a member net loss due to assignment of substantially all of the safe harbor rent expense to member operations. Of far greater significance, however, the IRS agent's allocation scheme also results in a large amount of nonmember net income, since the nonmember interest income from the promissory note has little offsetting safe harbor rent expense.

As described earlier, member net losses cannot be used to offset nonmember net income under Section 277 of the Code of 1986, so the overall effect of the agent's allocation methodology is to create large annual tax liabilities to WFEC. Indeed, the taxes and interest which would result from applying the IRS agent's methodology could force WFEC to file for protection from creditors.

As was mentioned earlier, other than the up-front cash payment, no cash exchanges hands throughout the 20 to 30 year term of the safe harbor lease. In fact, since there is no income throughout the term of the lease and legal title to the safe harbor asset has not changed hands, the seller-lessee makes no entries at all for the safe harbor lease on its financial books after recording the up-front payment. Logically, in order for a taxpayer to incur sizable income tax liabilities year in and year out, he or she should have enjoyed large incomes in those years. The safe harbor lease produces no such income. When the economics of this transaction are considered, fairness and equity hold strongly for the G&T allocation methodology over that advocated by the IRS revenue agent.

CURRENT STATUS

WFEC asked the IRS revenue agent to seek technical advice from the IRS National Office in March 1986. The revenue agent agreed and a technical advice request was submitted. A formal response to the technical advice request, however, was not received until December 1991. The National Office stated in its response that it agreed with the revenue agent's allocation methodology. Thus, WFEC had to wait over five and a half years for the IRS National Office to render a formal decision on a member/nonmember allocation question about which the agency had provided no prior formal guidance to taxpayers. In this time period and continuing to the present, WFEC has been left in a state of uncertainty, a large contingent tax liability severely restricting its ability to raise capital. Defending its position with the IRS has also harmed the cooperative by diverting its staff resources from other critical tasks over this long period of time.

Since receiving its technical advice, WFEC has made several offers of settlement. Specifically, WFEC has proposed to the IRS a compromise allocation method whereby the interest income from the promissory note would be netted against the rent deduction; then, the net rent deduction would be allocated between member and nonmember operations based on usage of the power plant. This compromise is the basis of the legislative proposal of Representative Brewster.

In the meantime, following direction provided by the National Office in its technical advice on WFEC, an IRS agent auditing another rural electric G&T cooperative has also proposed the IRS allocation methodology on a safe harbor lease transaction completed by that G&T.

Our industry has attempted to resolve this member/nonmember allocation issue legislatively since 1987. Each time, our clarifying provision has been stripped from the final tax bill. I understand that Congress believes the safe harbor leasing law was flawed. The issue of our industry is, however, not a question of safe harbor leasing, but one of member/nonmember allocation methodology, which is unique to cooperative taxation.

I understand that some members of the full Committee have expressed concerns over the supposed "retroactivity" of the provision supported by Representative Brewster. NRECA however, strongly believes that the proposal is so constructed only because of the five and one-half years' delay caused by the IRS in its formulation of a response to the request for technical advice in the WFEC audit and in the subsequent delays due to IRS deliberation over an offer of settlement tendered by WFEC.

The U.S. Department of Treasury states in its testimony before this Subcommittee that it opposes the Brewster proposal because it applies to a "certain group of taxpayers." We respectfully disagree with this assertion. While the universe of rural electric cooperatives is small and the universe of G&Ts smaller yet, each is unique. Their financing arrangements, therefore, are also unique, in order to meet the varying individual needs of rural electric consumer-members and distribution systems across the country. The financial and power-supply needs of 14 G&Ts during the late 1970s and early 1980s, along with overriding economic conditions helped shape the decisions made by those G&Ts. To imply, as the Department of Treasury does, that Representative Brewster's proposal is some kind of unfair advantage for one or two taxpayers strikes us as a misrepresentation of the legislative proposal.

The Department of Treasury further argues that it opposes a clarification of cooperative tax law because the provision "permits retroactive relief." Such retroactivity would not have been necessary if the IRS had provided public guidance on the application of Section 277 of the Code relative to safe harbor leasing when questions began to arise in the early 1980s. Indeed, the economics of many of the G&T safe harbor transactions would have precluded the deals if the IRS' position were publicly known at the time. However, the IRS now proposes to apply a standard of member allocation under Section 277 it released in December 1991 on transactions whose genesis dates back to the early 1980s, to taxpayers with past tax returns still subject to audit under the statute of limitations. The Department's opposition on the basis of retroactivity seems strange given that the IRS is proposing essentially a "retroactive" application of a standard which destroys the economics of transactions which were completed over a decade ago.

As to the Department's assertion that "these transactions were structured with knowledge that there was a difficult tax issue regarding the application of [S]ection 277 to the transactions," NRECA once again disagrees. To imply that all G&Ts knew there were problems with Section 277 member allocations on safe harbor leases does not accord with NRECA's understanding of the situation faced by the 14 G&Ts. It is NRECA's understanding that the G&Ts proceeded on the assumption that the required standard, as specified in the 1972 proposed regulations under Section 277, was a "reasonable and consistently applied" allocation.

NRECA is surprised to learn that the Department of Treasury opposes legislative clarification due to the Department's contention that the issue "should be left to judicial resolution." This is the first time, in our experience, that Treasury has recommended that Congress not legislate on an issue because the courts ought to decide. WFEC informs us that the issue is of such great import that they are willing and ready to litigate, even though that is a costly process and needlessly detracts from their staff's primary duties of running a rural electric G&T cooperative. NRECA would hate to see a protracted legal battle in the courts when a tested legislative solution could be enacted during the 103rd Congress.

IMPACT ON RURAL ELECTRIC COOPERATIVES

As to G&Ts for which the IRS allocation methodology would not mean bankruptcy, wholesale rates would have to be raised to cover sizable tax liabilities, both for open past tax years and in the future until expiration of the safe harbor lease term. The increased wholesale rates, of course, must be passed on in the retail and commercial rates of distribution cooperatives, ultimately to be borne by rural consumers and businesses. This rate instability could threaten the ability of G&Ts and their distribution members to repay government loans made through the Rural Electrification Administration (REA), thus endangering a federal investment which was made before the advent of safe harbor leases. The price paid for energy is a bedrock component of decisions made by businesses on where to locate and how to conduct their activities. Any action by the federal government, such as acceptance of the IRS allocation methodology, which necessitates raising rates paid for electricity by those living and working in rural areas simply endangers the rural economy further.

Rural electric cooperatives are already facing increased cost in the REA financing program as a result of budget reconciliation. In addition, the proposed BTU tax would impact significantly on rural people. Thus, rural America is not shirking its responsibility to pay a fair share to reduce the Federal deficit. Attempts by the IRS to impose large unanticipated tax liabilities which result from inequitable member/nonmember allocation schemes, however, are neither fair to electric cooperatives nor a rational approach by the federal government to deficit reduction.

CONCLUSION

The proposal by Representative Brewster would resolve the member/nonmember allocation issue for WFEC and the other G&Ts which entered into safe harbor leases. The IRS has taken a position which is unfair to these G&Ts. Indeed, the IRS position destroys the economics of the safe harbor lease so that the G&T would have been far better off never to have entered into the transaction at all. This result to G&Ts clearly was never the intent of Congress in enacting safe harbor leasing; rather, Congress enacted safe harbor leasing in order that marginally profitable enterprises could make use of tax benefits associated with capital assets. Since by definition marginally profitable enterprises do not have sufficient taxable incomes to make use of these tax benefits themselves, the benefits would have gone unutilized without safe harbor leasing. The ability to sell tax benefits was enacted to make the incremental cost of capital of marginally profitable enterprises more comparable to that of profitable businesses, which can always fully utilize their tax benefits.

Representative Brewster's proposal is a fair compromise which falls between the allocation methodology adopted by the G&Ts on their tax returns and that advocated by the IRS on audit. Your support of this proposal is urged and very much appreciated.

WRITTEN COMMENTS OF DELTA QUEEN STEAMBOAT COMPANY IN SUPPORT OF COST RECOVERY PROPOSAL TO ALLOW THE CAPITAL CONSTRUCTION FUND (CCF) TO BE USED TO ACQUIRE OR CONSTRUCT PASSENGER VESSELS OPERATED IN THE DOMESTIC TRADE

Introduction and Summary

The Delta Queen Steamboat Co. ("Delta Queen") appreciates this opportunity to submit a written statement in support of the proposal to extend the CCF program to passenger vessels acquired or constructed for the domestic trade.

Delta Queen provides cruises of America's inland rivers on the only two overnight paddlewheel riverboats still in existence: the historic DELTA QUEEN and the newer and larger MISSISSIPPI QUEEN. Over 35,000 passengers annually cruise for 2-12 days on the Mississippi, Ohio, Cumberland and Tennessee Rivers through America's heartland, calling on scores of towns in fourteen states.

Delta Queen plans to build a new third riverboat. However, this $60+ million undertaking is a significant effort for a company whose net income was less than $5 million annually and yet, unfortunately, the company is unable to use the existing federal tax-deferral CCF program to help finance the vessel's construction, because that program is currently limited to vessels constructed for the foreign, Great Lakes or non-contiguous domestic trade.

Thus Delta Queen strongly supports the extension of the CCF program to apply to passenger vessels operating in any U.S. domestic trade (i.e. coastwise trades and on the inland waterways). This change:

- Will create many new U.S. jobs in our shipyards, on board ship, and in urban waterfront areas where the vessels call;
- Will help U.S. companies operating U.S.-flag vessels compete for the American vacation cruise market against the handful of foreign companies operating foreign-flag vessels in the foreign trade which currently dominate;
- Is strongly supported by maritime labor and the shipyards; and
- Is supported by the Merchant Marine and Fisheries Committee (which has reported legislation, H.R. 2152, including such a change).

Background: Delta Queen And Its Plans To Build A Third Riverboat

Delta Queen, headquartered in New Orleans at the Robin Street Wharf, provides cruises of America's inland rivers on the only two overnight paddlewheel riverboats still in existence: the historic DELTA QUEEN and the newer and larger MISSISSIPPI QUEEN. Delta Queen employs a total of 550 people. 150 work in the headquarters office in New Orleans. Another 400 work on board the vessels, the majority of whom are members of either the Seafarers International Union or the Marine Engineers Beneficial Association, District 2.

Delta Queen intends to construct a third riverboat to be named AMERICAN QUEEN. This vessel would be roughly equivalent in size to the MISSISSIPPI QUEEN and thus would carry approximately 436 passengers and a crew of 165.

Delta Queen has signed a contract with McDermott Shipyard in Louisiana to begin the two-year construction job later this year.

However, this $60+ million undertaking is a significant effort for a publicly traded company (NASDAQ) whose net income is less than $5 million annually. A key problem is the company's inability to use the existing federal tax-deferral Capital Construction Fund (CCF) program to help finance construction of the new vessel. However, Delta Queen has proceeded with its plans to construct the new vessel in part because of the support expressed by many Members of Congress to extend the CCF program to cover such construction.

Problem: The CCF Program Cannot Currently Be Used To Build Passenger Vessels For the Domestic Coastwise Trades And Inland Waterways

The CCF program was created to assist owners and operators of U.S.-flag vessels accumulate the capital necessary for the modernization and expansion of the American fleet.[1] The CCF program encourages and assists the construction of U.S.-flag vessels through the deferment of federal taxes. Deposits into a CCF are exempt from current federal taxation; in return, a company's tax basis in a new vessel is reduced, thereby reducing depreciation deductions the company may take over time, so that the government gradually recoups its taxes.

Under the CCF program, "eligible vessels" produce income which may be deposited into the CCF. "Qualified vessels" are those new vessels for which withdrawals may be made from the CCF. Eligible vessels may operate anywhere and their earnings be deposited into a CCF. Currently, however, withdrawals from a CCF to help construct a qualified vessel may only occur if that vessel is operated in the U.S. foreign, Great Lakes or non-contiguous domestic trade -- but not in other domestic trades.

The limitation on permitting the CCF program to be used to construct vessels for the coastwise and inland domestic trades apparently was imposed out of a concern that it would unfairly advantage barge operators in competition with rail and truck transportation. Unfortunately, the result also has been to preclude use of the program to help finance passenger vessel construction.

Solution: Extend The CCF Program To Passenger Vessels Operated In All Domestic Trades

The definition of a "qualified vessel" for purposes of the CCF program (Section (k) of the Merchant Marine Act of 1936, as amended) should be expanded In order to include passenger vessels constructed for all the domestic trades. Note that because the CCF program has been codified both as Section 607 of the Merchant Marine Act of 1936 (46 App. U.S.C. 1177), and as Section 7518 of the Internal Revenue Code, any changes to the CCF program must be made both to the Merchant Marine Act and the IRC. This means that the sections of both the IRC and the Merchant Marine Act which rely on the definition of "qualified vessel," must be amended to incorporate the expanded definition of "qualified vessel" in Section 607(k).

There are good reasons to support the proposal.

The proposal will create many U.S. jobs. The construction and operation of new U.S. passenger vessels will create new U.S. jobs not only in shipyards and aboard the vessels, but also in the urban waterfront areas where the vessels call. For example, the Delta Queen Steamboat Company, which operates two passenger vessels along the Mississippi and other inland rivers, generates millions of dollars in portside business through supply purchases and tourist visits.

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[1] The CCF program was established as Section 607 of the Merchant Marine Act of 1936 (46 App. U.S.C. 1177). The program was subsequently expanded as part of the Merchant Marine Act of 1970. The program was further modified as part of the 1986 Tax Reform Act and, at that time, also was codified as Section 7518 of the Internal Revenue Code.

The proposal also will promote maritime competition. Today, the vacation cruise business is dominated by a handful of foreign companies operating foreign-flag vessels in the foreign trade -- even though 80% of passengers are Americans! U.S. companies want to provide cruises on U.S.-flag vessels operating in the domestic trade--such as between U.S. ports or along the Mississippi. In order to compete effectively, however, these companies need access to the CCF. Providing them with such access is consistent with the policies underlying the CCF (to offset foreign competitors' tax advantages).

Finally, note that the proposal is supported by the Merchant Marine and Fisheries Committee. On May 26, 1993, the Merchant Marine and Fisheries Committee unanimously ordered reported H.R. 2152, the Merchant Marine Investment Act of 1993. The bill seeks to encourage American investment in new U.S.-flag vessels to be built in U.S. shipyards by changing our maritime tax policies to more closely reflect those of our foreign competitors. Importantly, the bill provides that CCF funds may be used to construct or operate vessels (including passenger vessels) in the domestic trades.[2] (See Section 2(a)(1), Section 2(a)(3)) The Committee also provided that withdrawals made after December 31, 1992, could be for vessels acquired or constructed for the domestic trades. (Section 5(b))

June 17, 1993

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[2] The Committee did specifically exclude "any towing vessel, barge, or dry or liquid bulk vessel operated on the inland waterways of the United States." The Committee retained the current prohibition on use of CCF funds to construct tugs and barges for operation on the inland waterways because the tug and barge industry feared that it could experience over-capitalization.

NEW YORK CRUISE LINES, INC.

Circle Line Sightseeing Yachts, Inc.
Hudson River Day Line, Inc
World Yacht, Inc

August J. Ceradini, Jr.
President

June 17, 1993

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of New York Cruise Lines and the 42 other member companies of the Passenger Vessel Association in New York, I am writing to ask your support for a proposal to allow the Capital Construction Fund tax-deferral program to be used to build U.S.-flag passenger vessels in U.S. shipyards. I understand that this proposal is among those select investment measures your Subcommittee presently is considering. According to information we have received, the impact of this proposal on the federal budget should be negligible.

The Passenger Vessel Association is a nationwide association of more than 500 companies that own, operate and supply U.S. flag passenger vessels. These include dinner cruise ships, tour and excursion boats, car and passenger ferries, private charter boats, domestic overnight cruise vessels, and environmental cruise boats. In New York we range in size from the South Bay Water Taxi in Islip to New York Cruise Lines, which operates the Circle Line Sightseeing Tours around Manhattan and World Yacht dinner cruises.

The Capital Construction Fund, as you know, was enacted by Congress years ago to help ship owners accumulate the capital needed to build or rebuild vessels in U.S. shipyards. Currently, however, only passenger vessels that serve the Great Lakes or the non-contiguous domestic trades may use the program. Those of us who operate vessels in New York as well as in other locations around the country, are excluded from the program.

Many of our passenger vessel operators here in New York are small, family owned businesses that have been hurt by the same lack of commercial credit which has hurt other small businesses in the state. If the Capital Construction Fund program were extended to include passenger vessels, it would help address this problem. The Capital Construction Fund is an established, proven program that would offer these smaller companies a new financing option that many earnestly need in order to build their fleets and stay in operation.

For these reasons, your assistance in making the Capital Construction Fund program more broadly available to the domestic passenger vessel industry would be greatly appreciated.

Sincerely,

August J. Ceradini, Jr.

Passenger Vessel Association
808 17th Street NW
Suite 200
Washington, DC 20006

June 17, 1993

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

On behalf of the Passenger Vessel Association (PVA), I would like to urge support for a proposal to allow the Capital Construction Fund (CCF) program to be used to construct or reconstruct U.S. flag vessels built in U.S. shipyards for use in domestic passenger service.

I respectfully request that this letter be made part of the hearing record on those miscellaneous revenue measures under consideration by your Subcommittee today, June 17.

Founded in 1973, PVA today represents more than 500 companies that own, operate and supply U.S. flag passenger vessels. These include dinner cruise ships, tour and excursion boats, car and passenger ferries, private charter boats, casino gaming vessels, domestic overnight cruise boats and environmental vessels. Member companies of the Passenger Vessel Association operate more than 1,200 vessels ranging in size from 7 to 4,000 passengers, and together employ several thousand people across the country.

For some time, the Passenger Vessel Association has sought a change in the Capital Construction Fund Program administered by the U.S. Maritime Administration to allow its use for the acquisition or construction of vessels intended for domestic passenger services. The CCF program permits the accumulation of earnings on a tax-deferred basis for the purpose of constructing in U.S. shipyards certain U.S. flag vessels. Under current law, however, deposits into a Capital Construction Fund may not be withdrawn for the construction of vessels intended for use in domestic passenger services, other than for the Great Lakes or non-contiguous domestic passenger markets.

Our Association views the Capital Construction Fund as an important financing option for our member companies. Our industry is growing, and is vibrant -- contributing millions of dollars to the national economy each year as part of the tour and travel industry. Yet many of our member companies are small, family owned businesses that have been hurt by the same lack of commercial credit which has plagued other small business owners in recent years. To grow, and replenish our fleet, we need to continually invest in new vessels. The Capital Construction Fund program offers our members an established, proven program that can help them accumulate the capital to meet this challenge. Based on information we have received, the impact of this proposal on the federal budget will be minimal.

The equity in extending the Capital Construction Fund to allow for the construction of passenger vessels already has been recognized. On May 26, the House Committee on Merchant Marine and Fisheries by voice vote ordered reported H.R. 2152, the Merchant Marine Investment Act of 1993. Among the provisions of that bill is one that would amend the Capital Construction Fund definition of "qualified vessel" -- those vessels for which CCF funds can be used -- to extend the program to all vessels intended for use in domestic passenger services.

As the Subcommittee on Select Revenue Measures proceeds to consider cost recovery and investment proposals to assist and enhance American industry, we urge that the proposal to extend the Capital Construction Fund for use in the construction of all passenger vessels in U.S. shipyards be among those adopted.

Sincerely,

Eric G. Scharf
Executive Director
Passenger Vessel Association

SAYVILLE FERRY
SERVING FIRE ISLAND
SINCE 1894

June 17, 1993

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman,

I am writing to ask you to support legislation to allow the Capital Construction Fund program to be used to build passenger vessels. I understand that this proposal presently is being considered by your Subcommittee on Select Revenue Measures, and I hope that you, as Chairman, will completely support this move.

My family has owned and operated the Sayville Ferry Service on Long Island since 1894. Today we operate eight vessels, carrying about 500,000 passengers every year between the South Shore of Long Island to Fire Island. My son is in the business with me, and we hope my grandson will follow in our footsteps.

There are many smaller passenger vessel operations like ours in New York and here on Long Island. We all would benefit greatly by any new financing option that might be made available to us. In this difficult environment, we need all the help we can get to maintain and grow our operations, and to stay in business. I'm told by other boat owners that the Capital Construction Fund can be an extremely useful program for helping people accumulate the capital needed to build or rebuild vessels, and we would like to be included.

On behalf of my own family, as well as others in similar situations here on Long Island, I would like to thank you in advance for your assistance. I look forward to your reply.

Sincerely,

Ken Stein, Jr.

Ken Stein, Jr.

KSJr/md

STATEMENT OF THE
AMERICAN AUTOMOBILE MANUFACTURERS ASSOCIATION
SUBMITTED FOR THE RECORD

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECTED REVENUE MEASURES
U.S. HOUSE OF REPRESENTATIVES

HEARINGS ON
MISCELLANEOUS REVENUE ISSUES

The American Automobile Manufacturers Association (AAMA) appreciates the opportunity to submit this statement for the record of the Subcommittee's hearings on miscellaneous revenue issues.

AAMA is the trade association for the domestic automobile manufacturing industry. Our members are Chrysler Corporation, Ford Motor Company, and General Motors Corporation. Together these three American corporations employ more than 600,000 workers directly and account for another 1,500,000 jobs through dealers and suppliers.

AAMA supports extending the applicability of Code Section 179 to all purchases of business-use automobiles and light-duty trucks by amending or removing the cap imposed by Section 280F of the Code. Section 179 allows small business to expense up to $10,000 of the cost of most depreciable assets in the year of acquisition. Under present law, Section 280F of the Code, there is a cap of $2,760 on the amount a small business can deduct for a business-use passenger car or light-duty truck in the first year through either depreciation or expensing.

Generally, business-use automobiles and light-duty trucks are the only assets that small business cannot expense as a result of the cap in Code Section 280F. They are the only assets that the Code limits the amount of capital expenditure that a small business can deduct in the first year through depreciation or expensing. As a result, the Code discriminates against business-use motor vehicles.

For example, a business asset costing $15,000 and not subject to the Section 280F limits would be allowed $10,000 first-year expensing under Section 179, plus full first-year depreciation on $5,000. In contrast, a business-use passenger car costing $15,000 would be limited to first-year depreciation of only $2,760 with no Section 179 expensing. Thus, Section 280F not only limits ordinary depreciation deductions for "luxury" vehicles, but also effectively disallows Section 179 expensing of the "non-luxury" cost (i.e., $12,960, the amount of non-luxury depreciation allowable under Section 280F over a vehicle's 5-year recovery period). No other business-use asset is subject to such limitations.

The Code's discrimination against motor vehicles has an enormous adverse impact on small businesses. The small business that spends its scarce capital on the purchase of a motor vehicle to improve efficiency and production is limited in the amount it can deduct in the first year and its cash flow is restricted. However, any competitor that chooses to expand by spending the same amount of capital on other assets -- computers, furniture, machinery, etc. -- is not limited in the amount it can deduct and thus gains a competitive advantage. Permitting purchasers of business-use passenger cars and light-duty trucks equal treatment under Section 179 would eliminate this competitive disadvantage.

The purchase of an automobile or light-duty truck is the major capital expenditure of many small businesses -- tradesmen, florists, farmers. Limiting their ability to deduct this business expenditure, either through depreciation or expensing, has serious cash flow implications. Industry economists project that allowing small business to expense vehicles in a manner similar to that afforded other assets under Section 179 would lower the present value of a vehicle's after-tax cost by 3-10 percent, depending on the price. For example, the after-tax cost of an average vehicle -- $17,800 -- would be reduced by approximately 9 percent.

Reducing the after-tax cost of business-use cars and light-duty trucks could lead to increased purchases of such vehicles. Assuming that autos and light-duty trucks have a price elasticity of 1, a reduction in after-tax cost of 3 -10 percent could result in motor vehicle sales to small businesses increasing between 3 and 10 percent.

Increased sales of motor vehicles to small businesses would increase their productivity as well as increase the economic well being of domestic automobile manufacturers and their suppliers. More than 95 percent of the business sector's purchases of passenger cars and light-duty trucks are products of domestic manufacturers. Based on U.S. Department of Labor data, for every increase in sales of 1,000 passenger cars and light-duty trucks there is a 150 person increase in employment among auto manufacturers and their suppliers.

In summary, AAMA urges the Subcommittee to allow purchasers of business-use passenger cars and light-duty trucks to expense and deduct under Section 179 the lesser of:

1. the amount allowed to be expensed under Section 179 (a maximum of $10,000 under present law), or

2. the maximum amount of depreciation deductions allowed during the recovery period under Section 280F ($12,960 before the inflation adjustment).

Any remaining basis after the application of the expensing allowance would become deductible as depreciation starting in the second year of the recovery period.

The proposal will aid small businesses and stimulate vehicle sales, resulting in increased employment among vehicle manufacturers and their suppliers throughout the nation.

D'AGOSTINO SUPERMARKETS 1385 BOSTON POST ROAD • LARCHMONT, NEW YORK 10538
TELEPHONE 914-833-4000

June 15, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: New Class for Leasehold Improvements under the Modified Accelerated Cost Recovery System.

Dear Ms. Mays:

D'Agostino Supermarkets respectfully submits the following comments to the Ways and Means Select Revenue Measures Subcommittee regarding a cost recovery provision to provide a new class for leasehold improvements under the modified accelerated cost recovery system with respect to non-residential real property.

The House Ways and Means Committee recently voted out a tax bill which would extend the recovery period for nonresiential real-estate property to 39 years. If this provision becomes law, the leasehold improvement made to business property must be recovered over a period of the life of 39 years, instead of the life of the improvements, a much shorter period.

Under the current tax law, D'Agostino Supermarkets and many other small businesses must use the 31.5 year amortization period, 40 years for AMT, even though their lease term of 10 years is much shorter than the 31.5 (40) years prescribed under the MACRS rules. Using the 31.5 (40) year depreciation schedule for leasehold improvements results in annual tax depreciation of 3.17 % (2.5%) which is much slower than actual useful life in the business.

The following chart shows the leasehold improvements we have made in the past two years, the amount of pre-tax income and the amount of income taxes paid due to the slower rate of amortization:

Fiscal Year	Leasehold Improvements	Pre-Tax Income	Income Tax Paid	% of Tax to Income
90/91	$ 2,359,914	586,000	760,000	130%
91/92	$ 2,801,252	543,000	691,000	127%

A new class for leasehold improvements to allow amortization over the estimated useful life or term of the lease would be economically correct and would allow D'Agostino Supermarkets to make necessary leasehold improvements as required by the business. Remodeling and improvements are especially essential to a supermarket which experiences heavy customer traffic and is a high priority for D'Agostino Supermarkets so that we may continue to provide quality service to our customers.

In our current American economy, investment and capital expenditures desperately need encouragement. Allowing retail stores to amortize their leasehold improvements to better correspond with the economic realities of the life of such improvements will encourage companies to invest in their property, which include investment in economically distressed areas. This expansion will further help to create jobs, which is a primary focus in reinvigorating the American economy. We therefore urge the Committee to review this situation, and find a solution that more nearly reflects the economic lives of the improvements made to retail property.

Respectfully submitted,

Nicholas D'Agostino Jr.

Nicholas D'Agostino, Jr.
Chairman
D'Agostino Supermarkets, Inc.

STEVE A. ROBERTSON, DIRECTOR
NATIONAL LEGISLATIVE COMMISSION
THE AMERICAN LEGION
TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE WAYS AND MEANS COMMITTEE
JUNE 17, 1993

For more than one year the opinion rendered by the General Counsel of the Internal Revenue Service (IRS) on February 27, 1992, which considered taxation of veterans benefits enacted after September 9, 1986, has languished in deliberation. The errors in this opinion have been pointed out in many pieces of correspondence between the previous Administration, veterans organizations, members of Congress and law firms.

In a letter from the IRS General Counsel to the General Counsel of the Department of Veterans Affairs noted that if a veteran defaults on a VA guaranteed loan and the veteran was granted a waiver of repayment dated prior to September 9, 1986, the VA must pay the lender and the veteran was not required to repay the VA. This is fair and understandable. The problem becomes more complex when determining whether a waiver of debt is granted under circumstances of "hardship", for not only home loans, but for many veterans benefits.

The conclusion in the IRS letter is that veterans who receive debt waivers under the 1986 law will not be taxed on benefits. However, if the veteran is given a debt waiver under post-1986 rules, the amount he is forgiven is considered taxable income by the IRS. Therefore, in the home loan default example, the veteran must declare the forgiven debt amount in his income tax statement, and that amount then becomes taxable.

Two things are wrong with this process. First, the reasoning used by the IRS was extremely broad and could be used to impose a tax on any other veterans benefits statutes enacted since September 9, 1986. COLA's, education benefits, categories of medical care, and rates of survivors dependency and indemnity compensation could be included in this consideration.

Second, the IRS did not address the relation of two pertinent sections of the tax code to one another. Specifically, they did not compare section 134 of the IRS Code to section 136. Since the Congress changed and adopted section 134 and deliberately did not amend section 136, this indicates Congress did not intend to change the tax exempt status of veterans benefits.

Veterans benefits provided to veterans and their survivors under laws administered by the VA, always have been distinct from military pay and benefits provided to active duty or retired service members under laws administered by the Department of Defense. In fact, Internal Revenue Code, Section 136 explicitly references the provision in title 38, United States Code, which makes veterans benefits exempt from taxation.

The American Legion supported legislation, H.R. 11, in the 102nd Congress to correct this problem; however, the measure was vetoed by then President Bush. We also thought the Treasury Department and the IRS had the authority and the responsibility to interpret Section 134, and thus allow a full exemption of veterans benefits from taxation. Such has not been the case.

Therefore, Mr. Chairman, you and your colleagues must resolve this issue once and for all. Representative G.V. (Sonny) Montgomery's proposed legislation, H.R. 786, contains the same language agreed to last year by the 102nd Congress, Department of Veterans Affairs, the Department of Treasury and Office of Management and Budget.

Since the law wasn't changed last year, The American Legion wants to ensure we never have to re-address this issue. The Legion strongly believes it is imperative this protective language be codified at the earliest possible date. We respectfully request, and urge you, to include Representative Montgomery's bill, H.R. 786, an amendment to the Internal Revenue Code of 1986 to clarify veterans benefits gross income exclusions as part of the tax measure under consideration.

Thank you for your continued leadership on this and other issues affecting America's veterans and their families.

Mr. Chairman, that concludes our statement.

STATEMENT OF LCDR DONNA M. CRISALLI, USN, ON H.R. 786, "A BILL TO AMEND THE INTERNAL REVENUE CODE OF 1986 TO CLARIFY THE EXCLUSION FROM GROSS INCOME FOR VETERANS' BENEFITS"

IN CONNECTION WITH THE SELECT REVENUE MEASURES SUBCOMMITTEE HEARINGS ON MISCELLANEOUS REVENUE MEASURES

I am a tax attorney and active duty service member personally interested in the taxation of veterans' and other military benefits. I have reviewed H.R. 786, which proposes to amend § 134 of the Internal Revenue Code, which provides a limited exclusion from income for "qualified military benefits." The apparent purpose of H.R. 786 is to restore the unqualified exclusion from gross income which applied to veterans' benefits prior to the 1986 enactment of § 134. The subcommittee should consider that H.R. 786 does not accomplish this purpose.

Prior to enactment of § 134 in the Tax Reform Act of 1986, veterans' benefits enjoyed a general exclusion from gross income under 38 U.S. Code § 5301(a) (and predecessor sections), which states that "payments made to, or on account of, a beneficiary shall be exempt from taxation..." The Treasury Department has taken the position that the unqualified exclusion of 38 U.S.C. § 5301(a) has been implicitly repealed by § 134. Therefore, like other military benefits, veterans' benefits presently may be excluded from gross income only if they are excluded by § 134 or another income exclusion provision of the Internal Revenue Code.

Section 134(a) provides that "gross income shall not include any qualified military benefit." A "qualified military benefit" is an allowance or in-kind benefit (except personal use of a vehicle), received by a servicemember or dependent by virtue of military status or service, which was excludable from gross income on 9 September 1986, the effective date of § 134. § 134(b)(1). The Internal Revenue Service interprets this provision to mean that no benefit *created or initially authorized* after September 9, 1986 can be a qualified military benefit.

Section 134 contains a second limitation, which precludes treatment of any post-September 9, 1986 *modification or adjustment* to a military benefit as "qualified," unless the modification or adjustment is pursuant to a law which was in effect on September 9, 1986 and which determines the modification or adjustment by reference to a fluctuation in cost, price, currency, or similar index. § 134(b)(3). Thus, increases in the *dollar amount* of a military benefit will not be excluded from income unless the increase satisfies the requirements of § 134(b)(3).

The income exclusion for veterans' benefits is therefore presently subject to these two limitations. H.R. 786 exempts veterans' benefits from § 134(b)(3) only; it would free veterans' benefits from the second limitation in § 134, but not the first. Under this approach, modifications or adjustments in veterans' benefits would be excluded from income as "qualified military benefits" even though the modification or adjustment was not determined by reference to an index; but veterans' benefits which have been initially authorized since September 9, 1986 would still be included in income. In order to restore the status of veterans' benefits to full tax-exemption, § 134(b)(1), as well as (b)(3), must be amended.

Thank you for considering these comments.

Donna M Crisalli
DONNA M. CRISALLI

STATEMENT OF
REPRESENTATIVE NICK J. RAHALL, II
BEFORE THE
WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEARSURES
REGARDING H.R. 736
JUNE 17, 1993

MR. CHAIRMAN: I would like to take this opportunity to thank you for holding this series of hearings. I very much appreciate that you have included H.R. 736, legislation which I have introduced, as one of the topics to be covered.

Last Congress and again this year, I introduced this bill in order to gain equity for retired military personnel who serve as Junior Reserve Officer Training Corps (JROTC) Instructors. In 1964, the Congress passed the JROTC Vitalization Act. This Act reaffirmed the important role that the JROTC program plays in our society. The Act also addressed matters of staffing for this program.

Prior to the 1964 Act, JROTC instructors were generally pulled from the active and reserve rolls. However, because of the impact on active strength level management, the law as enacted gives the services the option of providing active duty, reserve or certified retirees as instructors. Employing retirees has become the general practice in the program. Today, approximately 5000 retired military personnel serve as JROTC instructors or administrators.

It is apparent that the 1964 Act did not intend to differentiate between active and retired JROTC instructors for the purposes of the military benefits portion of their allowances. Unfortunately, the Internal Revenue Service refuses to recognize this provision without a specific change to the tax laws.

Employment for active duty, reserve or retired military personnel who are JROTC instructors is conditioned on continued military certification. They must wear the proper uniform of the applicable branch of the service. They must comply with military standards in regard to weight, appearance, and grooming; as well as other required military duties.

Furthermore, the instructor must attend various seminars and conferences conducted by the service branch. Performance of requested military duties is required, such as local parades, military funerals, color presentations, etc... Also, an annual evaluation of the instructor is given by military superiors in the chain of command. All of these requirements are the same for JROTC instructor, whether he be active duty, reserve or retired.

A JROTC instructor is hired by the school district in which the program has been established. The school district pays the instructor's salary. In the case of a retiree, compensation is the difference between his military pension and what he would receive for military pay and allowances if returned to active duty. The school district is then reimbursed by the proper military service branch for one-half the amount of the instructors salary.

The instructor's compensation is received broken down into base pay and allowances. These allowances, subsistence, uniform and housing, are the same allowances which are received by members on active duty and which are exempt from taxation under current law.

Because the JROTC instructors on retired status are in every sense similar to those who are on active or reserve status, many of these instructors have excluded the allowances from their gross income with mixed results. In some cases, there has been no action on the part of the Internal Revenue Service to challenge this action. In others cases, the exclusion of the allowances has been challenged and approved and in still others, the exclusion is challenged and disallowed.

It is about time that Congress makes it clear that these people are doing the same job and face the same requirements as active duty personnel. It is important that retired military JROTC instructors be allowed the same exemptions as their active duty counterparts.

My bill would simply amend the Internal Revenue Code of 1986 relating to exclusion of military benefits to include those earned by retired members of the armed services serving as administrators or instructors in Junior Reserve Officer Training Corps.

The approval of this measure by Congress will go along way to acknowledging the critical role that JROTC instructors play in our society. These people perform an active part in the formative years of many of our youth.

Considering all the recent debate about the lack of values display by our citizenry, the goals of the JROTC program ought to be encouraged at every turn. These goals are to develop informed and responsible citizens; to strengthen character; to help form habits of self-discipline and to develop respect for and an understand of the need for constituted authority in a democratic society.

For these reasons, it is my hope that this committee will consider the provisions of H.R. 736. I understand that the Chairman has some reservations about the language of this bill as presently written, especially in light of another bill dealing with taxation of veterans benefits which you are also considering. However, I look forward to working with the committee to resolve these differences.

Again, Mr. Chairman, thank you for the opportunity to testify today.

DEMOCRATS

G V (SONNY) MONTGOMERY MISSISSIPPI
DON EDWARDS CALIFORNIA
DOUGLAS APPLEGATE OHIO
LANE EVANS ILLINOIS
TIMOTHY J PENNY MINNESOTA
J ROY ROWLAND GEORGIA
JIM SLATTERY KANSAS
JOSEPH P KENNEDY II MASSACHUSETTS
GEORGE E SANGMEISTER ILLINOIS
JILL L LONG INDIANA
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BOB CLEMENT TENNESSEE
BOB FILNER CALIFORNIA
FRANK TEJEDA TEXAS
LUIS V GUTIERREZ ILLINOIS
SCOTTY BAESLER KENTUCKY
SANFORD BISHOP GEORGIA
JAMES E CLYBURN SOUTH CAROLINA
MICHAEL KREIDLER WASHINGTON
CORRINE BROWN FLORIDA

MACK FLEMING
STAFF DIRECTOR AND CHIEF COUNSEL

ONE HUNDRED THIRD CONGRESS

G V (SONNY) MONTGOMERY
CHAIRMAN

U.S. House of Representatives
COMMITTEE ON VETERANS' AFFAIRS
335 CANNON HOUSE OFFICE BUILDING
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REPUBLICANS

BOB STUMP ARIZONA
CHRISTOPHER H SMITH NEW JERSEY
DAN BURTON INDIANA
MICHAEL BILIRAKIS FLORIDA
THOMAS J RIDGE PENNSYLVANIA
FLOYD SPENCE SOUTH CAROLINA
TIM HUTCHINSON ARKANSAS
TERRY EVERETT ALABAMA
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JACK QUINN NEW YORK
SPENCER BACHUS ALABAMA
JOHN LINDER GEORGIA

July 1, 1993

Honorable Dan Rostenkowski
Chairman, Committee on Ways & Means
US House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

As an original cosponsor of HR 786, I wholeheartedly support it. You will recall that an identical provision was contained in the Conference Report on HR 11, which passed last year. The purpose of this legislation is to restore the unqualified exclusion from gross income which applied to veterans' benefits prior to enactment of the 1986 tax code. In addition, HR 786 enjoys a revenue neutral status and is non-controversial in nature.

Since HR 786's introduction, it has come to my attention that some of the language may need to be adjusted to reflect the clear intent of Congress to ensure the continued exclusion of veterans' benefits from taxation. Please note the enclosed statement by LCDR Donna M. Crisalli, USN, in which she outlines her concerns about subsection 134 of the 1986 Tax Reform Act relating to the exclusion from gross income of veterans' benefits and her recommendation to provide clarifying language to that effect.

As you are aware, historically, veterans' benefits have been specifically exempted from income taxation under a provision of Title 38, United States Code. However, last year's Treasury interpretation of a provision of the 1986 tax code raised some questions as to what veterans' benefits really are and whether they qualify for a tax exclusion.

Since it has never been the intent of Congress to tax the benefits paid to those deserving veterans who defended our freedom, I urge your Committee to take whatever action is appropriate to clarify the language contained in the 1986 tax code to reaffirm the long-standing tax treatment of veterans' benefits.

Thank you for giving me the opportunity to provide my views for the record on this very important issue since my schedule precluded me from testifying before your Committee in person.

Sincerely,

BOB STUMP
Ranking Republican Member

BS/sf
Enclosure

[SEE LISTING FOR DONNA CRISALLI TO SEE HER STATEMENT]

CHAMBERS OF
BENJAMIN K. MILLER
CHIEF JUSTICE
SUPREME COURT OF ILLINOIS

FIRST OF AMERICA CENTER, SUITE 580
ONE NORTH OLD STATE CAPITOL PLAZA
SPRINGFIELD, ILLINOIS 62701

July 7, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
United States House of Representatives
1102 Longworth
Washington, D. C. 20515

Dear Ms. Mays:

As Chief Justice of the Supreme Court of Illinois, I support the statements and conclusions contained in the attached statement submitted as a substitute for testimony before the Select Measures Subcommittee of the House Ways and Means Committee by Carl Lund, Chairman of the Trustees of the State of Illinois Retirement System and member of the Illinois State Board of Investments.

Sincerely,

Benjamin K. Miller

BKM/bs

This statement is a substitute for testimony before the Select Measures Subcommittee of the House Ways and Means Committee. It relates to the matters heard by the subcommittee on June 17, 1993, and should be made part of the records of that hearing.

The nondiscrimination provisions of sections 401(a) and 410 of the Internal Revenue Code have created irreconcilable problems for State governments. Over the years, separate pension plans have been established for different positions in State government. The conditions and benefits for judges, legislators, and elected executive officers differ from each other and from the plans for full-time, protected employees of State governments. The different benefits, both in necessary tenure and percentage of salary, are inducements to participate in public service--thus giving up law practices and other business interests. In Illinois, almost all those receiving greater retirement benefits are periodically subject to elections, contribute a higher percentage of their own salary, and do not have civil service protection.

An additional problem faces some States, such as Illinois, which constitutionally prohibit reduction of public employee pension benefits after employment. In comparison with State employees, the Illinois judges' and legislators' retirement plans have both a higher retirement benefit (higher percentage of salary) and a shorter service requirement to earn the maximum benefit.

Because of the constitutional prohibition, the only way to comply with sections 401(a) and 410 would be to require the State of Illinois to increase all State employees' retirement benefits to equal benefits of the judicial and legislative systems. Every pension system financed by the State of Illinois is seriously underfunded. To so increase the benefits of all nonelected State employees would, for obvious economic reasons, be impossible.

The abuses in the private sector sought to be addressed by sections 401(a) and 410 nondiscrimination provision do not exist in the governmental sector. Application of these provisions to judicial and other plans covering elected officials can only result in plan disqualification under the IRC. This would punish men and women who have decided to give up many of the benefits of the private sector to serve in public life by subjecting their accrued benefit to immediate taxation. Also taxing income from retirement fund investments would add an additional burden on State government.

Unless judicial and other plans covering elected officials are exempted from sections 401(a) and 410, judges and other elected officials in Illinois, as well as in many other States, will be tragically affected.

Carl A. Lund

Chairman of the Trustees of the State
of Illinois Judges' Retirement System
and member of the Illinois State Board
of Investments.

TWENTY-FOURTH JUDICIAL CIRCUIT
OF VIRGINIA

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COMMONWEALTH OF VIRGINIA
CITIES OF LYNCHBURG, AND BEDFORD
COUNTIES OF AMHERST, BEDFORD, CAMPBELL AND NELSON

June 30, 1993

The Honorable L. F. Payne, Jr.
Congress of the United States
House of Representatives
1110 Longworth Building
Washington, D. C. 20515

Re: Application of Proposed I.R.S. Nondiscriminatory Rules to State Judicial Retirement Plans

Dear Congressman Payne:

As my Representative in Congress and in my capacity as Chairman of a Judicial Compensation and Retirement Committee for Virginia, I seek your help on proposed I.R.S. changes which would have a detrimental effect on Virginia's Judicial Retirement System. While I cannot officially speak for all other Virginia judges, I feel sure that the action which I request reflects the sentiment of the Virginia judiciary. Although there is no immediate legislation pending, it is my understanding that the I.R.S. has announced plans to apply the nondiscriminatory section of I.R.S. Code 401 (a)(4) to state judicial pension plans. For reasons stated herein, I feel that such action would be entirely inappropriate and unworkable.

The I.R.S. rules are predicated on the assumption that an employer has structured the pension plan to benefit a few, highly paid managers. Most of our plans, however, treat all employees, the judges of a particular jurisdiction, equally. Second, the rules assume that the designers of the plan are also those who receive the benefits. But judicial pension plans are designed and adopted by an outside body, the legislature, with the approval of another outside party, the governor. Those who will benefit have no direct say in the structure of the plan.

In the past, private sector and public sector retirement plans have been treated differently by the I.R.S. because they developed under completely different legal rules. Because public sector salaries and benefits are not now comparative with private sector plans, the proposed I.R.S. action would have a serious impact on attracting and retaining qualified judges. The quality of justice would be affected and the gap between benefits for State and Federal judges would be widened. In addition, the unique position that judges occupy demands that retirement systems for judges be distinguished from the systems for other state government employees and from private sector plans. Further, the I.R.S. proposal, if enacted, would create serious constitutional problems at the State level. The cost to the State and its taxpayers to comply with highly technical and complex nondiscriminatory rules and related tests would be enormous.

It is my understanding that a Bill to exempt state judicial plans from application of the nondiscriminatory provisions has been or will be introduced in Congress. In your capacity as an influential member of the Ways and Means Committee, I strongly urge your opposition to the I.R.S. proposal to extend the nondiscriminatory sections to public sector plans such as state retirement, and I urge your support of a Bill to exempt state systems as in the past.

I will call you later today to discuss this matter in more detail, and I will attempt to answer any of your questions. With best personal regards of the writer, I am

Yours very truly,

Bill Sweeney

William W. Sweeney, Judge

WWS/bdn

STATEMENT

OF

THE COMMITTEE OF ANNUITY INSURERS

The Committee of Annuity Insurers appreciates this opportunity to express our support for a provision considered during the Subcommittee on Select Revenue Measures' series of hearings on miscellaneous revenue issues.[1] That provision, which appears in the Subcommittee's June 2, 1993, press release on page 3 as item 3 under "Employee Benefits," would "provide that an annuity refund feature should not prevent an annuity owner from fully recovering basis under Code section 72(b)." This proposal addresses a technical flaw in section 72 which, in some circumstances, prevents an annuity owner from recovering tax-free his or her full investment in the contract. This problem affects both nonqualified and qualified annuities.

Background. Under section 72(b)(1), a portion of any "amount received as an annuity" is excluded from gross income. The excluded portion is determined by multiplying the amount received by the so-called "exclusion ratio," i.e., the ratio of the "investment in the contract" to the "expected return" under the contract.

The "investment in the contract" is the aggregate amount of premiums or other consideration paid for the contract, minus the aggregate amount previously received under the contract which was excluded from gross income. Section 72(c)(1). However, the investment in the contract is reduced by certain "payments in the nature of a refund of the consideration paid." Section 72(c)(2). The adjustment to the investment in the contract to take into account a refund feature has been part of section 72 since 1954.[2]

1986 Act: Prior to 1986, the exclusion ratio applied to all amounts received as an annuity without limitation. Thus, if the annuitant lived longer than expected, an amount greater than his or her actual consideration paid might be recovered tax-free. Concomitantly, if the annuitant died prematurely, the consideration paid would never be recovered for tax purposes.

The Tax Reform Act of 1986, Pub. L. 99-514 (the "1986 Act"), amended section 72(b) to limit the amount excluded from gross income under the exclusion ratio to the investment in the contract. See section 72(b)(2). The 1986 Act also added section 72(b)(3) which provides generally that when payments cease by reason of the annuitant's death and there is "unrecovered investment in the contract," the unrecovered amount is allowed as a deduction.

The Problem: The 1986 Act amendments have worked well where there is no refund feature. However, when a refund feature is present, as a result of the 1986 amendments, the exclusion ratio does not apply to amounts received as an annuity after the investment in the contract, as reduced for the value of a refund feature, is recovered. Thus, the portion of the full investment in the contract that is equal to the amount of the refund feature adjustment can never be recovered under section 72(b).

Example: A life annuity contract is purchased by an age 65 male with a single premium of $20,000. The contract provides lifetime payments of $100 per month and, in addition, a benefit upon the death of the annuitant equal to any unrecovered premiums (i.e., $20,000 minus amounts already received by the annuitant). This "return of premium" benefit constitutes a refund feature within the meaning of section 72(c)(2). See Treas. Reg. section 1.72-7.

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[1] The Committee of Annuity Insurers is a coalition of 45 life insurance companies which account for more than half of the annuity premiums in the United States. A list of the member companies is attached.

[2] As defined in Treas. Reg. section 1.72-7(a), a refund feature exists if (1) the amount receivable an as annuity is dependent, in whole or in part, on a continuing life, (2) the annuity contract provides for payments to a beneficiary at the death of the annuitant if a specific duration or amount of payments have not been made, and (3) the payments to the beneficiary are in the nature of a refund of the consideration paid. Common examples of annuities with refund features are a life annuity with a guaranteed term certain or a life annuity with a guarantee that the total payments will be at least equal to the consideration paid.

The investment in the contract equals $20,000. However, the investment in the contract must be reduced by the value of any refund feature. The refund feature adjustment determined under section 72(c)(2) and Treas. Reg. section 1.72-7 equals $2,800. Accordingly, the adjusted investment in the contract equals $17,200 ($20,000 - $2,800). The expected return determined under section 72(c)(3) and Treas. Reg. section 1.72-5 equals $24,000. Thus, the exclusion ratio under section 72(b)(1) equals 71.7 percent ($17,200 ÷ $24,000).

Pursuant to section 72(b)(2), the exclusion ratio does not apply after the adjusted investment in the contract ($17,200) is recovered. Also, the deduction under section 72(b)(3) for the unrecovered investment in the contract at the time of an annuitant's death is limited to the unrecovered portion of the adjusted investment in the contract. Thus, $2,800 of the investment in the contract can never be recovered by the annuitant under section 72(b).

If a beneficiary actually receives a refund benefit (e.g., upon the death of the annuitant), the refund feature adjustment may be recoverable by the beneficiary tax-free under section 72(e) to the extent of the refund benefit actually received. See section 72(e)(5)(E) and (6). However, if no refund benefit is paid (e.g., in this example, where the annuitant received during life payments equal to or in excess of the premiums paid), the investment in the contract to the extent of the refund feature adjustment can never be recovered. Also, even if a refund benefit is paid, to the extent that it is less than the refund feature adjustment, part of the investment in the contract will never be recovered.

The Solution: The full investment in the contract would be recovered in all events if both the after death deduction (section 72(b)(3)) and the rule limiting the total amount excluded under the exclusion ratio (section 72(b)(2)) were tied to the full investment in the contract rather than the investment in the contract reduced for the refund feature adjustment.

Technically, this solution could be implemented by amending section 72(b)(4)(A) by adding the phrase "(determined without regard to section 72(c)(2))" after "annuity starting date". Thus, amended section 72(b)(4)(A) would read as follows:

> (A) the investment in the contract as of the annuity starting date (determined without regard to section 72(c)(2)), reduced by

Another possibility would be to amend section 72(c)(2) to make clear that the reduction in the investment in the contract is solely for purposes of determining the exclusion ratio described in section 72(b)(1).

* * *

This technical flaw in section 72 is believed to be inadvertent and has remained undiscovered until recently. Therefore, the Committee of Annuity Insurers urges the Subcommittee to accept the proposal to provide that an annuity refund feature should not prevent an annuity owner from fully recovering basis under section 72(b).

COMMITTEE OF ANNUITY INSURERS MEMBER COMPANIES

Aetna Life & Casualty Insurance Company, Hartford, CT
Allstate Life Insurance Company, Northbrook, IL
American General Corporation, Houston, TX
American International Group, Inc., Wilmington, DE
American Investors Life Insurance Company, Inc., Topeka, KS
Broad, Inc., Los Angeles, CA
Capital Holding Corporation, Louisville, KY
Charter National Life Insurance Company, St. Louis, MO
CIGNA Insurance Companies, Philadelphia, PA
Confederation Life Insurance Company, Atlanta, GA
Conseco, Inc., Carmel, IN and Amarillo, TX
Delta Life and Annuity, Memphis, TN
Equitable Life Assurance Society of the United States, New York, NY
Equitable of Iowa Companies, DesMoines, IA
F & G Life Insurance, Baltimore, MD
Fidelity Investments Life Insurance Company, Boston, MA
Financial Benefit Life Insurance Company, Boca Raton, FL
Great Northern Insured Annuity Corporation, Seattle, WA
Hartford Life Insurance Company, Hartford, CT
The Holden Group, Los Angeles, CA
IDS Life Insurance Company, Minneapolis, MN
Integrity Life Insurance Company, New York, NY
Jackson National Life Insurance Company, Lansing, MI
John Alden Life Insurance Company, Miami, FL
John Hancock Mutual Life Insurance Company, Boston, MA
Kemper Investors Life Insurance Companies, Chicago, IL
Keyport Life Insurance Company, Boston, MA
Life Insurance Company of the Southwest, Dallas, TX
Life Insurance Company of Virginia, Richmond, VA
Lincoln National Corporation, Fort Wayne, IN
Manufacturers Life Insurance Company, Toronto, Canada
Merrill Lynch Life Insurance Company, Princeton, NJ
Metropolitan Life Insurance Company, New York, NY
Monarch Financial Services Inc., Springfield, MA
Mutual of Omaha Companies, Omaha, NE
Nationwide Life Insurance Companies, Columbus, OH
New England Mutual Life Insurance Company, Boston, MA
New York Life Insurance Company, New York, NY
North American Security Life Insurance Company, Boston, MA
Protective Life Insurance Company, Birmingham, AL
Reliance Life Companies, Philadelphia, PA
Sun Life of Canada, Wellesley Hills, MA
Travelers Insurance Companies, Hartford, CT
Western United Life Insurance Co., Spokane, WA
Xerox Financial Services Life Insurance Company, Oakbrook, IL

July 20, 1993

WRITTEN STATEMENT OF THE ESOP ASSOCIATION ON H.R. 1807, PROVIDING SPECIAL RULES FOR CERTAIN GRATUITOUS TRANSFERS OF EMPLOYER SECURITIES TO AN EMPLOYEE STOCK OWNERSHIP PLAN (ESOP) FOR THE BENEFIT OF EMPLOYEES, TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, JUNE 17, 1993

Chairman Rangel, and members of the Subcommittee, The ESOP Association and its nearly 1,000 corporate members who sponsor ESOP plans, and its 600 Associate members who provide advice to ESOP sponsors, appreciate the opportunity to present written testimony on H.R. 1807, a bill providing special rules for certain gratuitous transfers of employer securities to an ESOP for the benefit of employees. The ESOP Association, based in Washington, D.C., at 1726 M Street, NW, 20036 telephone #(202) 293-2971, is the only national trade association representing ESOP companies.

We have reviewed H.R. 1807, which provides special rules for certain gratuitous transfers of employer securities to an ESOP for the benefit of employees. The legislation would make it possible for an estate to transfer stock indirectly to an ESOP through a charitable remainder trust that is a beneficiary of the estate and claim an estate tax deduction for such transfer.

Although The ESOP Association does not oppose the efforts of those who propose narrow legislation like H.R. 1807, in the event the House Ways and Means Committee decides to send H.R. 1807 to the House Floor for a vote, The ESOP Association strongly recommends that the bill be expanded to permit: (1) charitable income, estate and gift tax deductions for direct transfers by individuals, trusts or estates to an ESOP; and (2) individuals to transfer stock during lifetime indirectly to an ESOP through a charitable remainder trust described in H.R. 1807.

But, The ESOP Association would take this opportunity to note that if the Ways and Means Committee wishes to consider legislation relating to ESOPs, it might in the future review the provisions of H.R. 2088, the ESOP Promotion and Improvement Act of 1993.

H.R. 2088 was introduced on May 12, 1993, with 42 members of Congress sponsoring the legislation, including 5 members of the Ways and Means Committee.

Of particular note is that this legislation contains provisions affecting Subchapter S corporations, which are also subject of your hearings, as set forth on page 3 and 4 of press release #4 announcing these hearings. These same provisions were included in the legislation H.R. 2410 of the last Congress, which attracted nearly 100 co-sponsors, including 12 members of the Ways and Means Committee. Ten co-sponsors of the 1992 legislation are current members of the Ways and Means Committee.

In sum, The ESOP Association does not oppose H.R. 1807; The ESOP Association seeks modest amendments to H.R. 1807; and, The ESOP Association would respectfully ask that in the future the Subcommittee consider ESOP legislation for which a significant number of members of the Ways and Means Committee have expressed support.

Written Statement by Robert G. Liberatore, Vice President-Washington Affairs, Chrysler Corporation, to the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives, Washington, D.C., June 17, 1993.

Mr. Chairman and members of the Subcommittee, I want to thank you for the privilege of submitting this written statement in lieu of a personal appearance at the hearing on the miscellaneous revenue issues announced by the Subcommittee on June 2, 1993.

Specifically, Chrysler Corporation fully supports item 5, under the Employee Benefits section of the June 2nd release, which provides:

> "A proposal to provide relief for employers from the excise tax liability resulting from increased funding of certain unfunded liabilities in qualified pension plans."

Today, the tax Code imposes an excise tax on nondeductible contributions to tax-qualified retirement plans. The excise tax, which originated in the Tax Reform Act of 1986, was intended to prevent employers from "stuffing" the plans with nondeductible contributions that create surplus, the earnings which accumulate on a pre-tax basis.

However, the excise tax has had an unintended effect. It has penalized companies such as Chrysler that are funding their retirement plans in excess of the minimum funding obligation in order to eliminate their unfunded pension liabilities more quickly. In many such situations, the additional pension plan contributions result in the nondeductibility of contributions, including pre-tax contributions by employees, to the companies' defined contribution plans, including 401(k) plans. Because these contributions become nondeductible, they become subject to the 10% excise tax.

Legislation such as that submitted with this written statement is needed to relieve Chrysler and other well-intentioned employers of the excise tax. Such relief should apply to an employer making contributions to its retirement plans that do not exceed the unfunded current liability. In such a situation, contributions to a defined contribution plan that are nondeductible due to retirement plan funding should be excluded from the excise tax base to the extent they do not exceed 6% of total employee compensation. Failure to allow such exclusions will have the unintended effect of discouraging aggressive pension funding.

Removal of the excise tax in this situation is good policy. It encourages pension funding which provides retirement security to workers and places less reliance on the benefit guarantees of the federal government, thus enhancing the solvency of the PBGC.

I appreciate the opportunity to present these comments. If the Subcommittee or any individual member wishes to discuss this subject further with me, a meeting can be arranged.

103D CONGRESS
1st SESSION

S. ___

To make a technical correction relating to the Pension Protection Act of 1987.

IN THE SENATE OF THE UNITED STATES

JUNE __, 1993

Mr. __________ introduced the following bill; which was referred to the Committee on Finance

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A BILL

To amend the Internal Revenue Code of 1986 to delete the excise tax on certain nondeductible contributions made to defined contribution plans.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. AMENDMENT TO DELETE THE EXCISE TAX ON CERTAIN NONDEDUCTIBLE CONTRIBUTIONS MADE TO

DEFINED CONTRIBUTIONS PLANS.

Subsection (c) of section 4972 of the Internal Revenue Code of 1986 (relating to tax on nondeductible contributions to qualified employer plans) is amended by adding at the end thereof the following new paragraph:

> "(6) Contributions to defined contribution plans. For any taxable year for which the limitation of section 404(a)(7)(A) applies to contributions made to or under one or more defined contribution plans and one or more defined benefit plans to which section 404(a)(1)(D) applies for the plan year which ends with or within such taxable year, the term "nondeductible contributions" shall not include any contribution made to or under any such defined contribution plan to the extent such contribution does not exceed 6 percent of the compensation otherwise paid or accrued during such taxable year to the beneficiaries under such plan."

SEC. 2. EFFECTIVE DATE.

The amendment made by section 1 shall apply to contributions made on or after January 1,1992 [and for taxable years beginning after December 31, 1991.]

WRITTEN STATEMENT OF THE ESOP ASSOCIATION TO THE SUBCOMMITTEE ON SELECT REVENUES MEASURES ON A PROPOSAL TO PROVIDE FOR A TAX CREDIT FOR CERTAIN CONTRIBUTIONS TO EMPLOYEE STOCK OWNERSHIP PLANS (ESOPs)

Mr. Chairman, and members of the Subcommittee on Select Revenue Measures, we are pleased to submit this written statement to you on behalf of The ESOP Association, the only national trade association of corporations that sponsor Employee Stock Ownership Plans, or ESOPs. Our nearly 1000 ESOP company members employ approximately 900,000 employee owners throughout America.

The author of this statement is J. Michael Keeling, President, The ESOP Association, 1726 M Street N.W. #501, Washington, D.C. 20036, 202-293-2971.

Since 1978, The ESOP Association has actively worked with members of Congress and officials of the Executive Branch on all matters affecting employee ownership and ESOPs. Needless to say, much of that work has included communications with members of the Ways and Means Committee. During that time, we feel that members of the Committee have listened to our views with open minds; and while we have never had 100% agreement from the Committee members with our views, we have found the Committee to be fair to employee ownership.

With this history and comment as background, we note that this written statement is on the proposal to create a tax credit for certain contributions to an ESOP, as described in the Joint Committee on Taxation Staff Description of Miscellaneous Revenue Proposals scheduled for Hearings September 8, 21 and 23 before House Ways and Means Select Revenue Measures Subcommittee (JCS-12-93) pp. 6-7.

Mr. Chairman, we have been down this road before.

While The ESOP Association will not directly oppose any attempt to establish a tax credit for ESOP contributions, such a tax credit is not a proposal we favor. In fact, working with this Committee and the Senate Finance Committee in 1984 and 1986, The ESOP Association endorsed legislation that repealed an earlier version of so-called tax credit ESOPs, and instead, endorsed 1984 and 1986 legislation that initiated more effective means of having our tax laws encourage the spread of employee ownership.

Let us remind ourselves why ESOP advocates were more than willing to have the old PAYSOP credit, and prior to that, the old TRASOP credit expire, or be repealed by Congress. The facts of the prior tax credit ESOPs were clear--for a very high revenue loss, only a small, and most cases, insignificant, amount of stock was contributed to the ESOP. These facts meant that often times the TRASOP or PAYSOP only held 1 to 5% of the employer securities of the sponsoring corporation. While we recognize that a 5% block of stock is very meaningful in many of our largest corporations, and while many of these corporations belong to The ESOP Association and lead the way in developing employee-employer alignment, the current ESOP tax incentives that led to these ESOPs are not as costly to the Federal Treasury as a tax credit.

We believe, and there is evidence to support this belief,, that many members of the House support employee ownership through ESOPs, and many want to encourage the expansion of employee ownership through ESOPs. For example, nearly 100 members of Congress have co-sponsored H.R. 2088, the ESOP Promotion and Improvement Act of 1993, which was introduced in Congress in late April of 1993. At least 10 of these members are members of the

Ways and Means Committee, and 4 are members of this subcommittee.

In fact, Mr. Chairman, your support for ESOPs and employee ownership, dating back to the early 1980's, is well-known.

So, if the Ways and Means Committee wishes to encourage employee ownership through ESOPs beyond the current incentives in existing law, the modest, yet meaningful, provisions of H.R. 2088, are a reasonable place to look.

To turn to a tax credit for ESOP contributions, an approach this same Committee repealed in the Tax Reform Act of 1986, is not reasonable, and is not an approach endorsed by The ESOP Association.

We would certainly honor any decision the Subcommittee made to encourage employee ownership, and this honoring would include your decision to re-enact the tax credit ESOP, in whatever permutation of earlier law.

But again, if you do take the direction of new law to encourage employee ownership, we commend to you the more modest provisions of H.R. 2088, which would encourage the creation of significant employee ownership and help existing ESOP companies.

AlliedSignal Inc. Written Statement for the Printed Record in Connection with the House Ways and Means Subcommittee on Select Revenue Measures September 8, 1993 Hearing on Miscellaneous Revenue Issues

The following comments are submitted on behalf of AlliedSignal Inc. by Ronald A. Sinaikin, Chief Tax Counsel, in response to the request of Congressman Charles B. Rangel (D-N.Y.) for written testimony on a proposal to permit an employer who sponsors an employee stock option plan (ESOP) to modify the ESOP to restrict in-service distributions of employer stock contributed to the ESOP prior to the date of legislation, if such stock will be rolled over by the participant to another qualified plan.

Prior to the enactment of the Unemployment Compensation Amendments of 1992, P.L. 102-318 (the "Act"), employee participants of qualified plans could not roll over distributions made to them while they were employed ("in-service withdrawals") to another qualified plan or to an IRA.[1] If the plan permitted, however, employees could make in-service withdrawals of company stock, without meeting the rigid requirements applicable to their elective contributions,[2] but those withdrawals would be subject to federal[3] (and likely state) income tax, as well as an additional 10% federal income tax if the participant was under the age of 59 1/2 [4] Allowing in-service withdrawals is completely elective to the plan sponsors, and many ESOPs do not permit them. The Act amended the rollover requirements, eliminating virtually all limitations, and provided that if the plan permits in-service withdrawals, the participants are allowed to rollover any amounts from the qualified plan to an IRA.[5] Any amount that may be rolled over also may be transferred directly from the qualified plan in which the employee is a participant to another qualified plan (including an IRA) designated by the employee.[6]

The ESOP sponsored by AlliedSignal Inc. provides for employer matching contributions, equal to a percentage of the amount of employee elective contributions (up to a maximum), to be made in company stock. As an ESOP, the Plan is intended to invest primarily in company stock.[7] Accordingly, the Plan provides for limits on the diversification of the investment in company stock that was contributed as an employer matching contribution.[8] One hundred percent diversification is allowed in the AlliedSignal Plan when a participant has reached age 55 and has 10 years participation. The Plan has historically allowed in-service withdrawals of the company stock contributed as an employer matching contribution.

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[1] Sections 402(a)(5) and 402(e)(4) of the Internal Revenue Code of 1986 ("IRC") generally provided that total distributions of a participant's account could be rolled over only if the distribution was made on account of death, separation from service, disability or after age 59 1/2 and partial distributions could be rolled over only in the case of the first three events. Thus, generally in-service withdrawals could not be rolled over.

[2] IRC Section 402(k)(2)

[3] IRC Section 402(a).

[4] IRC Section 72(t).

[5] IRC Section 402(c)(4) as amended by the Act defines an "eligible rollover distribution . . . as any distribution to an employee of all or any portion of the balance to the credit of the employee on the qualified trust. . ." except a distribution that is one of a series of periodic distributions being made for life or at least 10 years or certain required distributions pursuant to IRC Section 401(c)(9).

[6] IRC Section 401(a)(31).

[7] IRC Section 4975(e)(7).

[8] IRC Section 401(a)(28).

The changes effected by the Act result in a fundamental change to the operation of the Plan that was not intended. The matching contributions reflect the desire by the company to give its employees an interest in the company. In AlliedSignal's case, eligibility to enroll will be available to all employees and, historically, approximately 80% of the eligible employees participate. The Plan provides for in-service withdrawals to allow employees access to the employer matching contribution. The significant tax cost associated with the in-service withdrawal, however, should limit in-service withdrawals of the company stock to circumstances where the employee really needs the money. The loss of a significant portion of the account balance to taxes, including the additional 10% tax for most employees, likely would prohibit use of the in-service withdrawal as a means merely to achieve diversification of the company stock that had been contributed by the employer.

The changes effected by the Act, however, would allow employees to freely diversify without the inhibition of the significant income taxes imposed upon an in-service withdrawal. Thus, employees who want to diversify their investment in company stock, simply could have the company stock rolled over to an IRA, free of any tax, where the stock could be sold, free of any tax, and the proceeds reinvested in other investments This would allow an employee who is not age 55 to diversify his investment in company stock outside of the Plan, while he could not achieve such diversification within the plan, frustrating the employer's desire to have employees maintain an interest in company stock.

The effect of the Act was to significantly change the terms of the Plan as they relate to diversification Since the Plan allowed in-service withdrawals, the Act has, in effect, added a new diversification provision to the Plan A loss of a significant number of shares of company stock through such diversification threatens the qualified status of the Plan as an ESOP. Moreover, the Plan cannot be changed to eliminate the in-service withdrawals with respect to existing account balances under provisions restricting the ability of plan sponsors to eliminate in-service withdrawal.[9]

AlliedSignal believes that this effect of the Act was unintended. Accordingly, we support a legislative change to allow any plan sponsor to electively prohibit in-service rollovers of company stock contributed by the employer whether before or after the date of the enactment of the Act, where several conditions are met First, the prohibition would be elective for each Plan and would be effected by a provision in the Plan Thus, any plan sponsor could allow the in-service rollovers. Second, the prohibition would apply only to in-service withdrawals. Thus, the prohibition would not affect portability When a participant leaves the service of the employer, full rollovers would be permitted. Third, the prohibition would apply only to company stock contributed by the employer This would limit the prohibition to cases where the employer desires to have employee investment in company stock. Fourth, the prohibition would not apply to the extent diversification is allowed in the Plan. Since it would make no sense to prohibit a rollover to prevent diversification outside the plan while allowing diversification in the plan, the prohibition would not apply to the extent the plan otherwise allows diversification. Finally, the prohibition would apply to company stock contributed to the plan by the employer at any time, whether before or after the enactment of the Act.

AlliedSignal believes that it is good for an employer to have employees at all levels maintain an ownership interest in company stock. On the other hand, the Plan provided for in-service withdrawals in the belief that employees should have access to such funds in emergency situations. A subsequently enacted law has converted that provision for in-service withdrawals to an allowance of rollovers of company stock outside the Plan. AlliedSignal would like to maintain both of those objectives within its Plan. There would be no significant revenue impact if the proposed legislation were enacted, because the rollovers that may be made under the Act would be tax-free; thus, prohibiting those rollovers should not result in a loss of tax revenues. Accordingly, AlliedSignal urges the approval of a legislative change as we have outlined above.

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[9] The anti-cutback rules of IRC Section 411(d)(6) would prohibit elimination of the in-service withdrawal right.

Respectfully submitted,

Ronald A. Sinaikin
Ronald A. Sinaikin,
Chief Tax Counsel
AlliedSignal Inc.

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PPG Industries, Inc. Written Statement for the Printed Record in Connection with the House Ways and Means Subcommittee on Select Revenue Measures September 8, 1993 Hearing on Miscellaneous Revenue Issues

The following comments are submitted on behalf of PPG Industries, Inc. by Raymond W. LeBoeuf, Vice President Finance and Chief Financial Officer.

PPG Industries, Inc. sponsors a tax-qualified Employee Savings Plan (the "Plan") which is qualified as an Employee Stock Ownership Plan. The Plan provides for employer matching contributions in the form of employer stock equal to a percentage of the amount of employee elective contributions (up to a maximum) and permits participants to withdraw these matching contributions while still employed. All of PPG's approximately 23,000 employees in the United States are eligible to participate in the Plan, and over 82% of them actually do participate.

The generous employer matching formula in the Plan is provided, in part, through the financial advantages afforded to ESOPs. In this way, benefits enure to both the Plan sponsor and to employee participants.

Prior to the enactment of the Unemployment Compensation Amendments of 1992, P.L. 102-318 (the "Act"), the Internal Revenue Code ("IRC") provided significant restrictions on the ability of employee participants of tax-qualified plans to withdraw funds and roll those funds over into another qualified plan or to an IRA.[1] Of particular relevance, employee participants were not generally permitted to rollover withdrawals which were taken before the employee terminated employment.

The Act amended IRC §402 eliminating virtually all the restrictions previously limiting withdrawals eligible for rollover.[2]

As an ESOP, the Plan is required to be designed to invest primarily in employer securities.[3] Accordingly, the Plan is designed to significantly restrict participants' right to diversify matching contributions of company stock to other investment funds available in the Plan. The Plan does permit 100% diversification when a participant reaches age 55.

In order to provide access to the funds in situations where employees are in need of such, the Plan has historically allowed in-service withdrawals of Employer-contributed Company stock. Prior to the amendments made by the Act, however, two significant tax disincentives functioned to discourage such withdrawals merely for the purpose of diversification -

> First, withdrawals were subject to federal (and, most likely, state) income tax, as well as an additional 10% federal income tax if the employee was under age 59-1/2.[4]
>
> Second, if the funds were reinvested, future earnings would be subject to tax as earned, as contrasted with the protection now afforded funds which are reinvested in either another tax-qualified plan or an IRA.

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[1] IRC Sections 402(a)(5) and 402(e)(4).

[2] IRC Section 402(c)(4) as amended by the Act.

[3] IRC Section 4975(e)(7).

[4] IRC Section 402(a) and 72(t).

The changes effected by the Act, however, allow employees to freely diversify since both of the tax disincentives have been eliminated with respect to in-service withdrawals. Employees who want to get out of an investment in company stock and diversify that investment can now direct that the stock investment be rolled over to an IRA, avoiding the tax on the withdrawal. Further, subsequent to the rollover, the employer stock can be sold, free of any tax, and the proceeds reinvested in other investments with the ability to defer tax on subsequent earnings.

PPG's ESOP was designed to provide access to employer stock in situations of need, to increase employees' ownership in PPG Industries, and to ensure that the Plan continues to comply with the Code's requirement that the Plan be invested primarily in employer securities.5 With the amendments made by the Act, employees who are under age 55 can now diversify investments in company stock outside of the Plan, thus defeating the ESOP's design aimed at protecting against such diversification. A loss of a significant number of shares of company stock through such diversification threatens the qualified status of the plan as an ESOP -- a result which clearly was not intended by the Act.

Moreover, even if PPG wanted to eliminate the ability of employees to make in-service withdrawals in order to preserve the employer stock base, such a Plan amendment appears to be precluded by the anti-cutback rules of IRC §411(d)(6).

Finally, no significant revenue impact would result from the proposed legislation since the rollovers that may be made under the Act are tax free. Prohibiting those rollovers will not result in a loss of tax revenues. Accordingly, PPG urges the passage of a legislative change that would allow an ESOP to restrict rollovers as discussed herein.

Respectfully submitted:

Raymond W. LeBoeuf
Vice President, Finance
PPG Industries, Inc.

NCOA®

Non Commissioned Officers Association of the United States of America

225 N. Washington Street • Alexandria, Virginia 22314 • Telephone (703) 549-0311

STATEMENT OF

LARRY D. RHEA
DEPUTY DIRECTOR OF LEGISLATIVE AFFAIRS

AND

MICHAEL F. OUELLETTE
DIRECTOR OF LEGISLATIVE AFFAIRS

SUBMITTED TO

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

U. S. HOUSE OF REPRESENTATIVES

ON

H. R. 2791 AND H.R. 2617

AND

MISCELLANEOUS REVENUE PROPOSALS

SEPTEMBER 23, 1993

Mr. Chairman, the Non Commissioned Officers Association of the USA (NCOA) is grateful for the opportunity to comment on H.R. 2791 (a bill to permit the recovery of certain tax overpayment on military disability severance payments), H.R. 2617 (Military Separation Retirement Benefits Act of 1993), as well as other concerns of the Association that are germane to today's hearing.

H.R. 2791

NCOA fully supports H.R. 2791 that provides much needed clarification and thereby eliminates the confusion that surrounds the refund of tax overpayment in connection with disability severance payments.

Military disability severance pay is computed under 10 U.S.C. 1212 and is awarded only where a personal injury or illness necessitates discharge due to an individual having been judged as medically or physically unfit for continued active military service. Disability severance pay is awarded to compensate the military member for the specific medical discharge and falls within the provisions of 26 U.S.C. 104(a)(4) which excludes from taxable income those amounts received for personal injuries or sickness resulting from active service in the armed forces.

A recent U. S. District Court decision, Eastern District of Virginia (St. Clair vs U.S.), upheld that

Chartered by the United States Congress

disability severance payments constitute amounts received for personal injury or sickness resulting from active service in the armed forces and, therefor, are excludable from gross income under Section 104 (a) (4) of the Internal Revenue Code. The Internal Revenue Service (IRS) Action on Decision notes acquiescence to the district court ruling.

Notwithstanding the IRS Action on Decision, many veterans have and are being denied the recovery of certain tax overpayment on disability severance pay based on the IRS three-year statute of limitations. H.R. 2971 proposes to waive the statute of limitations, remove the bars to recovery of any other law or rule of law (including res judicata) and thereby permit credit or refund of such overpayment if a claim is filed within one year of enactment. Further, H.R. 2971 would authorize the Secretary of the Treasury to credit or refund any overpayment within the one year period following enactment without the requirement to file a claim for such overpayment.

NCOA strongly supports H.R. 2971 and urges the subcommittee to seek its quick enactment.

H.R. 2617

MILITARY SEPARATION RETIREMENT BENEFITS ACT OF 1993

The Association also appreciates the opportunity to comment on H.R. 2617 and recognizes the efforts of this subcommittee to consider the Military Separation Retirement Benefits Act of 1993, that amends the Internal Revenue Code of 1986 to permit rollovers of separation pay from the Armed Forces into Individual Retirement Accounts (IRA). NCOA fully supports the adoption of this legislation as a badly needed addition to the Department of Defense (DoD) transition package available to military members who are separated under programs designed to assist the services meet the military force reduction goals established by Congress. These voluntary and involuntary separation programs, SSB (10 U.S.C. 1174a) and VSI (10 U.S.C. 1175) are designed to reduce the armed forces by separating personnel prior to their reaching military retirement eligibility. These programs assist the military member by providing monetary assistance for transition and readjustment purposes.

For many years, NCOA has supported virtually every legislative effort to permit investment of military pay into IRAs since military personnel have no vested retirement protection until reaching retirement eligibility at the 20-year service point. For the most part, the Association's pleas have fallen on "deaf ears" since retirement eligibility normally could be attained unless a military member was separated earlier for qualitative or disciplinary reasons.

In the Association's view, past arguments opposing the investment of military pay into IRAs are no longer relevant. Large scale force reductions have rendered hollow the supposition that military retirement is virtually assured. The fact that military personnel have no retirement protection under law was clearly illustrated by enactment of the SSB and VSI programs. Only recently was the 18-year service safety net enacted to protect the service investment of those members having eighteen but less than twenty years of service.

NCOA is particularly grateful to the Congress for recognizing the plight of the enlisted military member by passing legislation extending the payment of involuntary separation pay to enlisted personnel and authorizing voluntary separation pay options, to include a considerable number of non-pay, post-service transition benefits. Nevertheless, military personnel are required to pay federal income tax on the total amount of separation pay at the time of receipt.

NCOA believes that the provisions of H.R. 2617 would provide a significant improvement to the overall force reduction transitional packages although significant numbers of enlisted personnel likely would be unable to take full advantage of the legislation. Information received from association members indicates that virtually the entire amount of separation pay received is required to make the transition into a very uncertain economy; however, for those members who are able to make a smooth and less costly transition, the incorporation of the IRA rollover feature into the SSB and VSI programs would be immensely beneficial. **For those individuals who have lost the military retirement option, the opportunity to contribute to an individual retirement fund and take advantage of the associated tax deferred incentives is of significant value to them and their families.**

RELATED TAX PROBLEMS

Further, the Association requests that the subcommittee consider other problems concerning the SSB and VSI programs specifically the problems associated with individuals who subsequently qualify for and receive veterans disability compensation.

SSB is a one-time payment computed in accordance with 10 U.S.C. 1174a. On the other hand, VSI is a multi-year annual separation payment program established in accordance with 10 U.S.C. 1175. Federal tax is withheld from the lump-sum SSB payment made to the service member and from the initial and annual payments of the VSI.

The provisions of 10 U.S.C. 1174a(g) and 1174(h)(2) and 38 C.F.R. 3700 (a)(5) clearly and unambiguously require that the total amount (pre-taxed) of any special separation benefit must be off-set from VA disability compensation. Recoupment of the total (pre-taxed) SSB or VSI commences when the Veterans Administration (VA) determines an entitlement to disability compensation as a result of illness or injury incurred in or aggravated by service in the armed forces. Since the SSB or VSI was paid by the military service to the member (now veteran), the individual veteran must repay the monies received to the VA.

In both cases, SSB and VSI, the readjustment and transition award received by the veteran is being repaid to the government. However, the IRS contends that the veteran must still pay taxes on the total SSB or VSI award irrespective of the VA disability compensation determination. **The net effect of the IRS contention is that veterans are being required to pay taxes on disability compensation in stark contrast to every other law, ruling, and precedent regarding taxability of disability compensation.**

IRS contends that SSB and VSI are not given as disability severance and, therefore, for income tax purposes, separation benefits and disability benefits are not the same money. Frankly, the Association agrees with the IRS on that particular point. **The Association, however, adamantly disagrees with the convoluted reasoning being applied by the IRS which, in effect, taxes the disability compensation of veterans who just happened to have had the misfortune of serving their country at a time of massive force reductions.** The reality in law that a veteran may only receive one is being completely ignored by the IRS.

SSB and VSI awards are designed to ease the transitional and readjustment problems associated with the abrupt termination of a military career. The two programs were constructed with a very clear and distinct purpose. It is equally clear that disability compensation has the distinct purpose of compensating the veteran for service connected illness or injury. **In the Association's view, the character of SSB or VSI dramatically changes at the point when a determination for entitlement to VA disability compensation is made.** In every other circumstance where VA disability compensation is awarded, such compensation is exempted as taxable income. To treat differently the VA disability compensation of veterans who were required to leave the military service as a consequence of Congressionally mandated force reductions is, in the Association's opinion, a blatant disregard for the service connected conditions suffered by those veterans during active service. Further, it heaps upon the disabled veterans a burden that complicates their readjustment opportunities. In addition to facing the reemployment problems faced by others, they must also contend with tax and medical problems.

Since the character and purpose of SSB and VSI awards are completely different from that of VA disability compensation, the Association strongly believes that there should be no connection whatsoever between them for any purpose, including taxation. **The Association strongly**

believes that VA disability compensation should be determined and awarded irrespective of any SSB or VSI program under which the veteran was separated. At a minimum, the Association believes that the gross taxable amount of SSB or VSI should be reduced by the equivalent amount of VA disability to which entitled were it not for the SSB/VSI recoupment requirement.

As previously stated, NCOA is grateful for the programs which have been enacted to ease the transition from military service. However, an unfortunate, and hopefully unintended, consequence of these programs is the additional tax liability incurred through having to compute SSB and VSI compensation in gross taxable income. Although federal income tax has already been withheld from the total SSB or VSI, the requirement to gross that compensation with other taxable earned income, raises the total tax liability considerably. **Therefore and within ‘he spirit of which the SSB and VSI programs were established, the Association requests that SSB and VSI be exempted as gross taxable income for the tax year in which received.**

CONCLUSION

In closing, NCOA appreciates the opportunity to express our thoughts and concerns on these important areas. The Association thanks the Subcommittee for consideration of our comments and recommendations.

Thank you.

American Society for Payroll Management
P.O. Box 1221, New York, NY 10025
(212) 662-6010

STATEMENT OF ROBERT D. WILLIAMSON, PRESIDENT, AMERICAN SOCIETY FOR PAYROLL MANAGEMENT FOR CONSIDERATION BY THE SUBCOMMITTEE ON SELECT REVENUE MEASURES COMMITTEE ON WAYS AND MEANS ON PROVISIONS RELATING TO THE EARNED INCOME TAX CREDIT (INDIVIDUAL INCOME TAX PROVISIONS)

Our members, the people in charge of payroll and employment tax operations at major firms, are involved in the earned income tax credit program because they must comply with the rules that require publicizing the program and provide for adding the credit to paychecks when requested by eligible employees. The comments that follow are based on anecdotal and empirical evidence.

*

G.1. Prohibition of fees assessed on employees who elect to receive the earned income tax credit on an advance basis

Once it is set up in the payroll system, making an advance payment does not result in additional employer burden or administrative expense. Therefore, we cannot see why there is a need for a statutory prohibition for charging fees for earned income tax credit advance payments when statutory prohibition is not needed for other employee-initiated payroll actions such as deduction for union dues, 401(k) deferral, and the like.

*

G. 2. Require employers to include earned income tax credit information with annual wage (W-2) statement

1. We oppose this proposal because it has been tried and found to be ineffectual.

This concept was embodied in Internal Revenue Service regulations issued in 1988 which required employers to provide the IRS Notice 797 "You May Be Eligible For the Earned Income Credit" to employees whose annual wages indicated they might be eligible, effective with the W-2s for tax year 1988. Notices were to be sent by first class mail or hand delivered. The rule specifically prohibited posting notices on bulletin boards and sending notices by inter-company mail.

Small employers probably could comply without much extra effort by inserting the Notice 797 with their eligible employees' W-2s by hand or by distributing the notices in the workplace. But the rule didn't work for large employers, because:

a. Many large firms, expecting they had few or none on the payroll who would be eligible according to 1988 limits, chose to ignore the rule (ASPM 1989 Survey). Some said they felt it made good business sense to pay the possible penalty for failure to give notice rather than to go to the expense of searching their records and complying for a small number of employees.

b. Highly-automated operations customarily used by large employers are not suited to selective transactions such as adding individual notices and, besides, most large employers print their own self-mailing W-2s that cannot accept enclosures. For large firms, the proposal would generally require them to make additional mailings at the busiest time of they year, when they are working overtime to get their W-2s out.

c. Some employers complied and mailed Notices 797 separately from their W-2s. An exceptionally responsible ASPM member in the hospitality business (a low-paid workforce) mailed 50,000 notices separately by first class mail and even translated it into Spanish and Vietnamese for distribution for some of its locations. Despite this extreme effort, few emplyees claimed the credit.

Responding to the chilling findings of an ASPM member survey that showed otherwise compliant companies were ignoring the 1988 rule and having taken into account the factors mentioned above, IRS, at our urging, allowed an alternative for tax year 1989: employers who printed their own W-2s would be deemed in compliance when they printed an IRS-approved shortened version of the Notice 797 on the back of the employee's copy of the W-2. And beginning with tax year 1990, IRS has printed the notice on their official forms. We see no justification for changing the existing rules.

2. EITC Publicity Should be Aimed at People Who Are Not in the Workforce, Not at Workers

The purpose of the earned income tax credit is to make lower-paid jobs more attractive, thereby "moving people from welfare to work..." [A Vision of Change for America, the President's Feb. 17, 1993 Report to Congress, page 59] Judging the program from this standpoint, intensifying employer information programs with Notices 797 to employees is off the mark because it is missing the real target audience, the people who are not working. This may explain why enrollments for advance payment are so infrequent. (The argument of some that employees need to know about the advance payment feature is not supported in practice. Data from ASPM surveys indicate that most earned income tax credit participants elect to receive the credit as a lump sum, similar to the tax refund that results from being overwithheld or the Christmas club at the bank.)

We suggest that the evidence shows that the proper vehicle for earned income tax credit information is not in the envelope with the W-2 form but the envelope with the welfare check. Community groups, social service agencies, and the like should educate their constituents about the program. When their clients understand the program, some will decide that the earned income tax is what will make work more attractive than welfare.

-end-

ASSOCIATED BUILDERS
AND CONTRACTORS, INC.

July 13, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
1102 Longworth Building
Washington, DC 20515

RE: Proposal to Modify Section 1938 of the Energy Policy Act of 1992 before Select Revenues Subcommittee

Dear Ms. Mays:

Associated Builders and Contractors (ABC), representing nearly 16,000 builders, contractors and construction suppliers, is writing to express its concern over changes to Section 162 (a) of the Internal Revenue Code, as amended by Section 1938 of the Energy Policy Act of 1992 and would like this following statement included in the hearing record.

Since there were no hearings or debate on this measure in the last Congress, ABC is pleased that the committee has provided construction representatives with an opportunity to be heard today. The construction industry is probably the single greatest user of this provision. It will have a significant impact on our industry, an industry that lost nearly a million jobs in the recent recession.

The primary effect of the change in the law is that construction costs will increase. If construction employees on temporary assignments are no longer permitted to deduct their temporary living expenses after 12 months, several things can happen. Some companies will try to increase the affected employee's compensation package so as to compensate them and make them "whole." Note, not all construction companies will be able to afford this remedy. To make up for the increased compensation, companies will be forced to add the costs to their bids and try to pass on the difference to their clients. Another scenario may have employers who are simply unable to adjust their employees' compensation upwards. This certainly impacts the morale of the employees, while threatening a company's livelihood by restricting mobility and the kinds of business opportunities it can pursue.

Construction is full of uncertainties and a work assignment is fraught with them. Construction is at the mercy of weather conditions, the availability of skilled personnel in the locale, change orders, and a host of other unforeseen circumstances. In light of these unique industry characteristics, ABC supports the following recommendations:

1300 North Seventeenth Street ■ Rosslyn, Virginia 22209 ■ (703) 812-2000

* A recent survey of the construction industry conducted by the Construction Financial Management Association (CFMA) showed that 30 percent of its members, which are representative of the industry as a whole, have contracts that last from one to two years and that many of the contracts exceed two years. In this regard, ABC asks the committee to consider legislation that would exempt the construction industry from taxes for temporary living expenses for projects lasting longer than 12 months.

* If a full exemption is not possible, in the alternate we urge the committee to remedy the one year requirement by changing it back to two years, or at least 18 months.

* Provide that all construction workers and employees, including engineers, supervisory staff, management personnel and others given temporary assignments are included and would remain eligible, subject to a facts and circumstances test, for the travel expense deduction. The description outline in the Joint Tax Committee's publication Description of Miscellaneous Tax Provisions, is too restrictive.

* Finally, ABC believes that making the loss of deduction retroactive to assignments that began in 1992 is especially harsh. In the interest of fairness, we urge the committee to provide relief by making the law applicable to assignments which began after January 1, 1993.

Again, we appreciate any assistance on this issue and look forward to working with the committee to devise a fair and equitable solution to the loss of deductions of temporary living expenses.

Very truly yours,

Charles E. Hawkins III, CAE
Senior Vice President

Statement of
Robert A. Georgine
President,
Building and Construction Trades Department, AFL-CIO

Before the Subcommittee on
Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

July 13, 1993

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to express the views of the Building and Construction Trades Department, AFL-CIO, a federation of 15 national and international building trades unions representing more than 4 million construction workers.[1] The Department strongly supports the proposed modification of Section 1938 of the Energy Policy Act of 1992, so that such provision does not arbitrarily prevent construction workers from deducting legitimate travel expenses they incur in the course of employment away from home.

It is a simple fact of life for construction workers that they must often accept employment at construction sites far from their homes in order to practice their trades. Even in the best of economic times, many construction workers cannot find work in their home areas. Just to keep food on the table, they must leave their homes and families and take temporary lodging--in a motel, apartment, trailer, or even tent--near the construction site.

These workers have no way of knowing whether their jobs away from home will still be there the next week--or even the next day. Accordingly, there is no way a worker can pick up and move his home to each distant job. When the job is over, the worker returns home and continues to seek work in his own area, but may end up having to take another temporary job away from home.

The typical American construction worker earns less than $30,000 a year. The costs of travel and lodging related to jobs away from home eat up a sizeable chunk of workers' wages. These costs are clearly legitimate business expenses, essential to the workers' performance of their jobs, and are not in any sense personal expenses. There is no question that the workers would prefer to find work closer to home.

Nonetheless, without any hearings or other opportunity for the Congress to hear from the affected taxpayers, the Energy Policy Act of 1992 placed an arbitrary limit on the deductibility of these expenses--they cannot be deducted if the job lasts more than a year. This new provision by its terms would disallow all deductions for travel expenses from the first day of the job, even if the worker has no idea that the job will last more than a year when he accepts the employment. Thus, if a worker takes a job at a distant power project expecting to work there only for six or nine months at the most, but then winds up working for more than a year due to unforeseen circumstances, he will lose all deductions for travel and lodging expenses for the entire period.

A job away from home may be unforeseeably extended for any number of reasons. The overall construction project, or a particular phase of it, could be delayed because of materials shortages, bad weather, accidents, design changes, loss of a funding source, unanticipated engineering or technical problems, or any of a variety of other unforeseeable difficulties. The occurrence of these unforeseen circumstances logically should not affect the worker's deductions, but the new statute has that arbitrary and unreasonable result.

A construction worker likely will not know how much longer his job will last even after he has been working six or nine months. The requirements for workers in particular crafts fluctuate tremendously on a given project during the construction process, and a worker will not know from week to week whether he will continue to be employed. Indeed, a worker may be laid off from a particular construction project on a number of occasions when the demand for his craft skills is low. When that happens, he has no way of knowing when he will be rehired at all. Workers in this situation look for other work, but may be rehired at the project after a few weeks, or even after a few days. There is a great deal of concern that IRS will ignore such layoffs and treat the workers' employment as continuous so as to cause the disallowance of deductions under the one-year rule.

Under prior law, which was in effect through the end of 1992, the determination whether travel and lodging expenses incurred in connection with a job could be deducted was made based on the applicable facts and circumstances. While we did not agree with the way IRS administered that prior law in many cases, those rules were substantially less arbitrary and provided a more theoretically sound result than current law. We support a return to these rules for construction workers, as provided in the proposal.

Construction workers are truly in a unique situation insofar as their travel expenses are concerned. Unlike workers in most industries, construction workers tend to work on a series of temporary jobs, whether in their geographic area or away from home. Further, their work is site-specific--they cannot plaster walls or lay bricks by phone or fax--so they are forced to travel to construction sites wherever those may be. The travel expenses of these construction workers are ordinary and necessary business expenses and should be deducted as such.

Construction workers who search out and take jobs away from home when none are available in their home area are fighting hard to support themselves and their families without resorting to unemployment insurance or, conceivably, welfare. The new law imposes significant economic hardship on them, and should be changed.

Thank you, Mr. Chairman.

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1. The unions affiliated with the Department are the International Association of Heat and Frost Insulators and Asbestos Workers; the International Brotherhood of Boilermakers, Iron Ship Builders, Blacksmiths, Forgers and Helpers; the International Union of Bricklayers and Allied Craftsmen; the United Brotherhood of Carpenters and Joiners of America; the International Brotherhood of Electrical Workers; the International Union of Elevator Constructors; the International Association of Bridge, Structural and Ornamental Iron Workers; the Laborers' International Union of North America; the International Union of Operating Engineers; the Operative Plasterers' and Cement Masons' International Association of the United States and Canada; the International Brotherhood of Painters and Allied Trades; the United Union of Roofers, Waterproofers and Allied Workers; the Sheet Metal Workers' International Association; the International Brotherhood of Teamsters, Chauffeurs, Warehousemen and Helpers of America; and the United Association of Journeymen and Apprentices of the Plumbing and Pipe Fitting Industry of the United States and Canada.

July 15, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Miscellaneous Tax Proposals: Construction Workers' Deduction for Travel Expenses Paid or Incurred in Connection with Employment Lasting More Than One Year

Dear Ms. Mays:

Information about CFMA

Established in 1981, the Construction Financial Management Association (CFMA) represents more than 5,000 financial managers in the construction business. CFMA members are employed by over 2,000 construction companies across the U.S., more than one-third of which have gross annual revenues ranging from $25-$99 million.

How the Construction Industry Works

Many of our contractors perform construction work over a large geographic area and, in doing so, it is normal practice to transfer a core management group to a remote jobsite and then to hire most of the other workforce locally. On such temporary assignments, it is common for contractors to reimburse these key employees for normal travel and living expenses incurred while away from home.

Why the Construction Industry Is Unique

Unlike most manufactured goods and products, buildings and highways take a long time to complete. A large number of construction contracts are bid on a competitive basis and result in **long-term, fixed-price** contracts for completion of specified work. These contracts normally do not include any provision for price adjustments due to changes in costs from taxes or other regulatory expenses.

The Energy Policy Act of 1992 requires that contractors treat travel expense reimbursements as wages for those employees on assignment in excess of one year. This provision adds potential additional costs that cannot necessarily be foreseen at the time projects are bid; therefore, these additional costs must be borne entirely by the contractor.

An Example of the Effect of the New Law

A construction employee is assigned to a job in a remote area which is expected to last 16 months and is reimbursed for travel expenses while at that assignment. Prior to the new rule, the travel expenses would have been deductible and the reimbursements not taxable, but now the assignment is considered indefinite and the reimbursements are treated as income to the employee.

Assume that the employee is married and has children. The family remains at the permanent residence, while the employee rents an apartment near the project site. The contractor will reimburse the employee $1,400 per month for travel expenses. This reimbursement (which was previously deductible) is now included in the employee's gross income and is subject to payroll taxes. The employee's take-home pay is only $831 after social security and federal income tax withholding of $569. If the project lasts 16 months, the employee would have $9,104 (16 x $569) withheld in taxes. The employee will not be able to exclude the travel reimbursement form his personal return nor deduct these expenses because the assignment lasts more than one year. (Unfortunately, both employees and contractors are now required by the Energy Policy Act of 1992 to pay additional taxes based on transactions which result in no economic improvement to either.)

The contractor would generally be required to compensate employees for the taxes withheld on the reimbursements so that employees will accept assignments at remote locations. If the contractor reimburses the employee for the $1,400 travel expenses net of taxes, the cost to the contractor is actually $2,360 (including an additional $960 to "gross up" the employee's take-home pay).

The contractor will also incur additional tax and benefit liability on the reimbursements to employees that were previously deductible. The "grossed up" wages of $2,360 times a payroll burden (the contractor's share of workers' compensation, social security, unemployment, retirement benefits, etc.) of 30% will produce a total cost to the contractor of $3,068. This is an increase in cost to the contractor of $1,668 per month for one person on this project. If the project last 16 months and there are five employees being reimbursed, the additional cost for the contractor is $133,440 ($1,668 x 16 x 5). The additional cost would then be multiplied by the number of projects that exceed one year, but are less than two years in length.

The Bottom Line

In the above example, the contractor will incur an additional cost of $133,440 (net of federal income tax) due to the new law. On fixed-price, lump-sum contracts negotiated before the change in the law, the contractor will bear this additional cost.

The other end result is to place an unfair burden on contractors working outside their "home" marketplace; it also places them at a tremendous disadvantage when bidding in the future against a contractor local to the project under bid. It is a *de facto* constraint of trade because it discourages contractors from expanding their marketplace unless they are willing to accept lower margins than local competitors - margins which are already stretched far too thin.

CFMA's Recommendations

* According to CFMA's 1992 *Construction Industry Annual Financial Survey,* approximately 30% of our members' contracts fall within the one to two year time-frame and many have contracts that exceed two years. Due to this unique and costly aspect of delivering construction projects, we request that the construction industry be exempt from taxes for travel reimbursement away from home for projects longer than 12 months.

* If exemption of the construction industry as a whole is not possible, then we strongly urge that the twelve month period be extended to an 18 month period.

* In addition, the retroactive application of this provision could negatively impact contractors due to circumstances beyond their control. Therefore, if not exempted, we request that on fixed-price contracts, the provision be applied only for the tax year in which it becomes apparent that the contract will exceed the 12 or 18 month limit (when the initial assignment was expected to be less than that limit.)

* Finally, the new law does not provide any relief for events that occurred before it was enacted. The change in the definition of temporary assignments is effective January 1, 1993, but applies to contracts that occurred in prior years. The new definition should only be applied to employees assigned to projects started after December 31, 1992. Construction projects started **before** January 1, 1993 should be allowed to use the old definition.

We appreciate the opportunity to submit our comments and have intended to show the negative impact of this provision, specifically on long-term, fixed-price contracts within the construction industry.

Sincerely,

Joseph J. Lozano
Chairperson
CFMA Tax Committee

American
Dental
Association

ADA

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Statement

Of The

American Dental Association

On

Restoring a Deduction/Credit
for Interest Paid On Student Loans (H.R. 1667)

Before The

Select Revenue Measures Subcommittee

Committee On Ways and Means

July 13, 1993

Thank you, Mr. Chairman and members of the Subcommittee on Select Revenue Measures, for the opportunity to submit a statement concerning the need to restore the tax deductibility of interest on student loans. As a member of the Student Loan Interest Deduction Restoration Coalition, the American Dental Association endorses the coalition's statement submitted to this committee at its July 13, 1993 hearing on Miscellaneous Revenue Issues. This testimony supplements that document by illustrating the degree to which high student loan indebtedness inhibits young dentists attempting to establish solo practices, especially in underserved areas.

Obtaining a dental education is a costly endeavor. For the 1990-1991 school year, the average first-year cost of tuition, fees and other educational expenses (excluding living costs) was $15,308 for state residents and $20,637 for out-of-state students.[1]

Increasingly, dental students, especially those from middle and low income families, must borrow much of the money to pay for their education. As a result of the increased demand for financialassistance, the average debt of a graduating dental student rose **$10,000 in just the last two years.** Specifically, the average indebtedness of the class of 1992 was $55,550, up from $45,550 in 1990.[2] In fact, many students graduate with a debt in excess of $100,000.

Dentists who would prefer to pursue careers in areas other than private practice, such as public health, teaching, research and the military may be forced to do otherwise. In fact, recently some dentists in the military have been forced to resign their commissions because military pay was inadequate to cover the cost of student loan repayments when coupled with other living expenses. For those who go into private practice, the inability to deduct interest on student loans is becoming an increasingly insurmountable burden.

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[1] The American Dental Association, *Key Dental Facts*, April 1993, p.7, reprinted from the American Dental Association, Council on Dental Education, *Annual Report, 1991-92.*

[2] *Ibid.*, reprinted from survey by the American Association of Dental Schools.

Making a hefty student loan payment each month without benefit of the student loan interest deduction makes it improbable that a young dentist will be able to open his or her own practice, especially in underserved areas where the remunerative opportunities may be limited. This will exacerbate the current lack of access to dental care existing in many parts of the country as solo general practitioners have historically provided the majority of dental care. In fact, solo proprietors continue to be the backbone of dentistry, as 78.5% of all practitioners fall into this category.[3]

The cost of establishing and maintaining a solo dental practice is high. The American Dental Trade Association estimates that it costs approximately $50,000 in equipment and dental supplies alone to establish a single operatory practice today. The median annual cost of maintaining that practice with one non-dentist employee would likely exceed $100,000. (see attachment)

Because of the exceptionally high cost of establishing and maintaining a solo dental practice, only dentists with very low student loans could hope to pursue such a goal and still earn a living wage. In fact, the median net income of solo general practitioners with under 5 years of experience was only $40,000 in 1991.[4]

The Association supports both H.R. 1667 and S. 271 as viable means of obtaining some financial relief for young practicing dentists faced with exceptionally high student loans. H.R. 1667, as introduced by Representatives Cardin (D-MD) and Bunning (R-KY) and S. 271, as introduced by Senators Grassley and Boren, would offer individuals the choice of a tax credit or deduction, within well defined limits.

The ADA agrees with other members of the Student Loan Interest Deduction Restoration Coalition that higher education borrowing should be recognized as an investment in human capital and treated accordingly in the tax code. We urge the Congress and the Clinton Administration to act this year to restore the deductibility of interest on student loans. Without such action all new graduates entering the work force will continue to be forced to seek the highest paid positions, regardless of societal and personal consequences. Young dentists, for example, will be prevented from pursuing careers in public health, teaching, research and the military. In addition, the absence of interest deductions for student loans also undermines the ability of young dentists to pursue a solo dental practice, which has historically best served the dental needs of the American public.

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[3] American Dental Association, The 1992 Survey of Dental Practice, "Income from the Private Practice of Dentistry", p. 2

[4] Ibid., p. 3,30. "Net Income" is defined as the dentist's personal income after practice expenses but before the payment of personal income taxes.

Attachment

SOLO GENERAL PRACTITIONERS
ANNUAL PROFESSIONAL EXPENSES, 1990

Item	Median
Rent	$11,820
Mortgage	13,000
Salary per non-dentist employee	12,670
Employee taxes	8,800
Employee benefits per employee	2,000
Dental supplies	12,000
Office supplies	3,500
Lab charges among dentists not operating their own lab	18,000
Advertising expenses	1,030
Malpractice insurance	2,000
Equipment depreciation	2,750
Business taxes	1,170
Equipment repairs	890
Office insurance	1,060
Legal and professional fees	1,200
Utilities	3,170
Professional expenses	1,590
Bad debts	500
Other	2,940
TOTAL	$100,090

Source: American Dental Association, The 1991 Survey of Dental Practice, "Annual Expenses of Operating a Private Practice", April 1992, p. 6 & 7.

THE MILITARY COALITION

201 North Washington Street
Alexandria, Virginia 22314

July 22, 1993

The Honorable Charles B. Rangel
Chairman, Select Revenue Measures Subcommittee
Room 1105, Longworth House Office Bldg.
Washington, D.C. 20515

Dear Mr. Chairman:

The Military Coalition, a consortium of 24 nationally-recognized military and veterans' organizations representing more than 3.5 million active, reserve, guard, and retired members of the military community, is pleased to note that the Subcommittee on Select Revenue Measures is considering H.R. 494, a bill to provide members of the armed forces, performing services in the relief effort in Somalia, entitlement to certain tax benefits in the same manner as if such services were performed in a combat zone.

In the absence of the President making a declaration of Somalia as a combat zone, our service men and women have been unable to take advantage of certain tax benefits normally available to soldiers serving under combat conditions. As Representative Mel Reynolds stated to the House of Representatives when he introduced this legislation on January 20, 1993, "There can be no question as to the danger and risk associated with the mission of mercy to the people of Somalia." Those proved to be prophetic words in light of the personal danger our troops have had to face recently.

At the same time that the subcommittee considers the exclusion from payment of federal taxes on pay earned in a combat zone for these service-personnel, the subcommittee should rectify the tax inequity that exists in combat-related pay for officers. Perhaps many members of Congress are unaware that officers are permitted an exclusion of only $500 per month, an amount that dates back to 1966, and has not been adjusted for inflation since then. Conversely, there is no limit on the tax exclusion for warrant officers and enlisted members.

During Operation Desert Storm, the Coalition sought to have the exclusion for officers increased to $2,000 per month. That ceiling recognizes the rise in inflation since 1966. In addition, to promote equity for all servicemembers, it would be appropriate to provide automatic adjustments in the ceiling, tied to increases in active duty basic pay. This would conform to the "de facto" automatic adjustment for warrant officers and enlisted members whose total compensation is excluded from taxation.

Mr. Chairman, we ask that you recognize the sacrifices that our service-personnel are making in a dangerous environment, highlighted by the fact that four U.S. servicemen were wounded this week alone in Mogadishu. The Coalition requests that the subcommittee support H.R. 494, and amend the bill so that it includes the necessary language to provide fair and equitable treatment to our officer personnel.

Sincerely,

Paul W. Arcari

Paul W. Arcari
Colonel, USAF (Ret)
The Retired Officers Assn
Co-Chairman

M Ouellette

Michael Ouellette
Sgt. Major, USA (Ret)
Non Commissioned Officers Assn.
Co-Chairman

Enclosure

STATEMENT OF JAMES H. LOCKHART
VICE PRESIDENT AND GENERAL COUNSEL
THE BAPTIST FOUNDATION OF OKLAHOMA

Subcommittee on Select Revenue Measures
Committee on Ways & Means
Hearings on Miscellaneous Revenue Issues
June 17, 1993 through July 13, 1993

MR. CHAIRMAN:

The Baptist Foundation of Oklahoma is the separately incorporated trust agency of the Baptist General Convention of the State of Oklahoma. Its role is to receive and administer gifts for Southern Baptist churches, ministries, agencies, and institutions in the State of Oklahoma. It also administers gifts that benefit the Southern Baptist Convention and its ministries, agencies and institutions within the United States and in foreign lands.

The Baptist Foundation of Oklahoma supports an amendment to correct the Generation-Skipping Transfer (GST) tax so as to exclude from GST tax all transfers to second generation persons where intervening ancestors are deceased. In instances where the intervening ancestor is deceased, the amendment should also apply to taxable terminations and distributions from trusts and to transfers to collateral heirs where the transferor has no lineal descendants.

Under current law, the above situations are subject to GST tax. Making such transfers subject to GST tax appears to be contrary to the intent to free transfers from this tax where there are not intervening family generations alive to inherit. Permitting transfers to persons where intervening ancestors are deceased, regardless of the circumstances of the transfer, is consistent with the public policy behind the GST tax. In these situations a person is merely leaving property (either direct or after an intermediate interest in a trust, perhaps to a charity) to those who survive him or her, not circumventing tax on the next generation.

Our concern about this is that taxing these transfers tends to restrict charitable giving in an area where we think the logic of the law was intended otherwise. Many Baptists give to Southern Baptist causes through trusts and wills which benefit their heirs and descendants. We believe that if this change is made, it will have an important impact on the financial support of many worthwhile Southern Baptist ministries and programs in Oklahoma, the United States and in foreign countries without compromising the public policy behind the GST tax.

The Baptist Foundation of Oklahoma respectfully recommends that the above changes be made.

STATEMENT OF CONGRESSMAN BREWSTER

Subcommittee on Select Revenue Measures
Committee on Ways & Means
Hearings on Miscellaneous Revenue Issues
June 17, 1993 through July 13, 1993

MR. CHAIRMAN:

In connection with the Subcommittee's consideration of miscellaneous revenue issues, I wish to bring to the Subcommittee's attention two corrections of a technical nature which need to be made to the Generation-Skipping Transfer (GST) tax, I.R.C. §§2601-2663. Although these hearings unfortunately will not include testimony on the corrections, I would like for the Ways & Means Committee to consider including them when it marks up a miscellaneous tax bill later this year.

The GST tax is imposed in addition to estate or gift taxes when property is transferred to any person more than one generation younger than the transferor. The purpose of the GST tax, which I strongly support, is to prevent persons from "layering" their estates between children and grandchildren, and using other devices to avoid payment of estate or gift taxes on property transferred beyond the generation immediately succeeding the transferor.

Consistent with this purpose, an important exception was written into the GST law to cover the situation where property is transferred to a grandchild not for any tax avoidance reason, but because the grandchild's parent (the transferor's child) is deceased at the time of the transfer.

Unfortunately, this exception, which is often referred to as the "predeceased parent exclusion," contains two flaws which I believe Congress did not anticipate when the law was enacted.

First, the exclusion covers transfers to lineal descendants only, and does not apply to transfers by childless individuals confronting similar circumstances. An individual without children who outlives all members of his own generation (siblings and cousins) and subsequent generation (nieces and nephews) cannot transfer property to his grandnieces and grandnephews -- his closest living relatives -- without the GST tax being applied, even though there is clearly no game-playing or attempted tax avoidance in the transfer to these collateral descendants.

Second, although Congress clearly intended that the GST tax be uniformly applied regardless of how property is transferred, the "predeceased parent exclusion" is inexplicably limited to direct gifts and bequests only; it does not apply to any type of transfer from a trust. I am especially concerned that this has the effect of strongly discouraging individuals whose direct gifts or bequests would otherwise be covered by the exclusion from establishing a charitable trust for some period of years before distributing property to family members. Such trusts are important sources of support for many types of charities, and it makes no sense to discourage their creation where unnecessary to accomplish the GST statute's objectives.

These two changes to the GST tax have been recommended by members of the Real Property, Probate, and Trust Law Section of the American Bar Association. In addition, there is substantial support for such changes from charitable organizations, including universities and foundations in my home State of Oklahoma and elsewhere in the country.

As an example of that support, I would like to introduce to the Subcommittee James H. Lockhart, Vice President and General Counsel of The Baptist Foundation of Oklahoma, who is submitting a separate Statement on behalf of his organization strongly supporting the measures I have outlined. The Baptist Foundation provides critical financial support for numerous social welfare programs and ministries within the State of Oklahoma, the United States, and foreign countries. Like any other charitable organizations, The Baptist Foundation depends upon the generosity of donors and volunteers to do its important work. Mr. Lockhart's statement explains how these unintended problems with the GST tax may have the effect of discouraging charitable gifts and bequests to his organization and why it is so important that Congress act to change the law as soon as possible.

I urge the Subcommittee's support for these changes in the GST statute.

Proposals[1] For Legislative Changes To Clarify The Relationship Between

Community Property Rights And Retirement Benefits[2]

By Edward V. Brennan*

Community property is an ideal system of ownership of marital property. This is the conclusion of Professor Lawrence W. Waggoner of the University of Michigan Law School in a recently published report of an in-depth study of marital property rights. He states:

> Community property reinforces a married spouse's sense of participation in the marriage and ownership of the marital estate. Separate property tends to place the nonpropertied spouse in a subordinate position.[3]

In order to protect community property rights, a second study by a task force of leading tax, employee benefits and estate planning lawyers representing most of the community property states is now recommending federal legislation to grant limited recognition to community property rights in qualified retirement plans.[4] This article is a report on this second study.

Initially, all members of the Task Force expressed a basic concern about the tide of less than thoughtful provisions in federal tax, employee benefits and labor legislation, which ignore and sometimes override community property rights. Many of the influential staff attorneys writing the tax and labor laws in Washington admit to an anti-community property bias. The various staffs have little or no expertise in community property law and no time to analyze the effect of it. When producing legislation they must reconcile complex and often conflicting policies and language under intolerable time constraints. As a result, they tend to throw into important legislation provisions such as "this section shall be applied without regard to community property laws," which is contained in a section of the Code dealing with IRAs (§ 408(g)). Fortunately, because the IRS has in fact construed the IRA provision to recognize basic community property rights, section 408(g) has not been used to divest spouses of their community property rights.

However, an exactly opposite result has occurred in the area of retirement plans subject to ERISA (the Employee Retirement Income Security Act of 1974)[5] as amended by REA (the Retirement Equity Act of 1984).[6] REA was enacted in 1984 because non-community property states had failed to provide and/or to preserve retirement benefits for spouses (mainly homemakers) of participants in qualified retirement plans. In an attempt to protect such nonparticipant spouses, Congress borrowed certain community property principles and mandated protections such as spousal annuities. The law, however, was hurriedly drafted by staff attorneys who admittedly had little or no understanding of community property. They overlooked the fundamental element of community property law which holds that each spouse actually owns a vested one-half interest in each community property asset. They also failed to appreciate the ability of community property states to adapt to federal tax and employment policies. In fact, before REA was adopted all community property states were in the process of developing methods of protecting the community property rights of spouses in all types of retirement benefits. This adaptation of community property rights to federally regulated tax benefits and employment policies was consistent with the history of community property law. Community property jurisdictions have always been able to adjust employee benefits (including federal retirement benefits), contract rights, partnership interests, and a host of other arrangements to community property concepts when given a chance to do so.

The federal agencies had historically cooperated in these efforts and had little concern about any disruption of legitimate tax or labor policies the recognition of such rights might cause. Indeed, the IRS issued a number of private letter rulings which indicated that community property interests within a qualified retirement plan could be recognized in such a way as to reflect the separate interests of husband and wife so long as there was no improper early distribution.[7]

The drafters of REA recognized that state courts had provided a nonparticipant spouse with certain protective rights to the participant's retirement benefits upon divorce. REA codified the practice of recognizing state court orders issued during a divorce, but the Act left unclear whether a state court order could protect the rights of a nonparticipant spouse in a community property state upon death.

The issue of whether the community property interest of a nonparticipant spouse in a qualified plan could be passed by such spouse on death to one other than the participant came before the Ninth Circuit in the case of *Ablamis* v. *Roper*.[8] The issue in *Ablamis* was whether a state court order transferring a community property interest on the death of a nonparticipant spouse could qualify as a QDRO (Qualified Domestic Relations Order). A majority of the court held that the amendments to ERISA made by REA preempted certain community property rights in qualified plans. The majority stated that REA's primary purpose was to protect the retirement rights of both the participant and the participant's spouse.[9] The majority held that these retirement rights were superior to any rights in the nonparticipant spouse to dispose of his or her interest absent a divorce.[10] The majority emphasized that retirement benefits have priority over death benefits and that this priority

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**Edward V. Brennan is a partner in the San Diego law firm of Gray, Cary, Ames & Frye.*

should obtain regardless of whether the nonparticipant spouse or the participant spouse dies first.

Since most nonparticipant spouses are women, many view the case as resolving a gender issue against the homemaker. This view is strongly set forth in a dissent by Circuit Judge Fletcher, the only woman judge to address the issue. Quoting from the U.S. Supreme Court in ***Hisquierdo* v. *Hisquierdo*** that "the whole subject of domestic relations of husband and wife, parent and child, belongs to the laws of the States and not to the laws of the United States,"[11] Judge Fletcher concluded that "the non-employee spouse's community property interest in the pension that is created by California law poses no conflict with federal law that justifies preemption" of California property law.[12] Judge Fletcher argued that it makes no sense "to allow the employee spouse to bequeath his interest in a pension but not to allow the non-employee spouse to bequeath her interest,"[13] and then concludes that —

> if the decedent had divorced her spouse before she died, she would have received as a matter of right her community interest in the pension earned as a result of her community effort and obviously could have bequeathed it. Having remained married, however, she forfeits her property rights in the pension plan and has nothing to bequeath to her family. Certainly Congress could not have intended these anomalous consequences.[14]

Judge Fletcher criticized the majority's ruling because it appeared "to be premised on the outmoded notion that those who forego careers to work in the home while their partners work outside it are not full partners in the economic partnership thereby formed."[15] Most members of the Task Force agree with Judge Fletcher's observations.

The problem with the *Ablamis* case is that the rule will unfairly deprive the nonparticipant spouse of the right to dispose of his or her community property interest on death even if the participant consents. A serious loss of such rights will occur in qualified retirement plans because state community property laws will not be able to address such federally protected benefits. However, as soon as the benefits are rolled over into an IRA the federal preemption rule will no longer apply and the state community property laws will control the rights of the parties. For example, California has enacted a statutory procedure to implement the postmortem distribution of such community property interests.[16] These procedures will apply to IRAs, but because of ERISA preemption, they will not apply to qualified plans. The inconsistencies will be dramatic -- spouses in community property jurisdictions will have totally different results depending on whether their retirement benefits are in qualified plans or IRA accounts. This lack of equity and consistency can only be resolved by federal legislation.

In response to the *Ablamis* decision, the Task Force studied many issues arising out of the interplay of community property laws and the federal laws governing retirement plans and IRAs, and determined that Congress must clarify how community property laws apply in the context of these federal schemes. Some of the difficulties the Task Force found are the result of the recent *Ablamis* decision. But other difficulties stem from various long-standing provisions of the Tax Reform Act of 1984[17], REA, and the Tax Reform Act of 1986.[18] The Task Force's recommendations provide a number of clarifications in federal law that will bring consistency and equity in the application of community property rules to retirement benefits.

The members of the Task Force unanimously favor obtaining federal recognition of community property rights in qualified retirement plans. The Task Force realized that under REA the participant spouse cannot alienate his or her benefit on death without the consent of the nonparticipant spouse. This same principle should apply when the nonparticipant spouse wishes to dispose of his or her interest in a plan to one other than the participant. Nevertheless, the nonparticipant spouse does have a community property interest which should be recognized and there seems to be no justification for depriving the nonparticipant spouse (or his or her estate) of such a benefit in the case of death if the participant consents to waive this federally protected retirement benefit.

The Task Force accepts the need for federal preemption on many issues involving qualified retirement plans, but unless the law is changed, inconsistencies and conflicts between federal law and actual economics will continue. In addition to addressing the preemption issue, the Task Force found it necessary to clarify the tax results of community property interests in retirement benefits under both federal income tax and federal estate and gift tax statutes. The goal was to achieve equity and consistency in the application of community property rules to retirement benefits. The tax effects should follow the economic realities of property ownership and transfer. Therefore, if the nonparticipant and the participant agree to allow the community property interest of the nonparticipant spouse to pass to third parties on the death of the nonparticipant, any transfer tax (estate or gift tax) estate tax should properly fall on the estate of the nonparticipant spouse and not on the participant or his or her estate.

The following example shows how the proposed legislation will clear up the present confusion in both property rights and retirement plans:

Harry and Sally live in a community property state. Each have children by a prior marriage. Sally also has an elderly mother who is partially dependent on Sally for support. The community property estate of Harry and Sally consists of a house worth $300,000 and Harry's profit sharing plan containing an account balance of $300,000 all of which was accumulated during their marriage.

Sally is a homemaker who does not have any retirement benefits other than her community property interest in Harry's plan. Without the proposed legislation Sally cannot utilize any of her $150,000 share of the profit sharing plan to support her mother or children if she predeceases Harry. The proposed legislation will allow Harry and Sally to agree that all or some portion of Sally's interest in the profit sharing plan may pass to Sally's mother and children.

Without the proposed legislation, Sally's $150,000 share will automatically pass to Harry who may already have significant separate resources of his own. Moreover, the $150,000 will be included in Sally's estate and technically could be classified as a nondeductible terminable interest which is not eligible for the estate tax marital deduction. Thus, even though Sally's $150,000 share passes to Harry by operation of law against their wishes, it may not receive the benefit of the federal estate tax law marital deduction. The proposed legislation will allow Sally's estate to qualify for a marital deduction under the qualified terminable interest property (QTIP) exception to the terminable interest rule.

The proposals will address the major deficiencies in the current law and will accomplish the following specific goals:

1. Allow a state court to issue a decree which, if it meets all of the other requirements of a QDR0, will allow the distribution of the nonparticipant spouse's community property interest in a qualified plan (or IRA) to someone other than the spouse. Such an order would have to be based upon a written agreement between the spouses. The written agreement will satisfy the requirement that no spouse be deprived of retirement benefits of a qualified plan (or IRA) without his or her consent. The requirement that the state court order meet all the requirements of a QDRO will ensure that the current administration of plans and IRAs will not be disrupted by burdensome new procedures. Plan administrators already have in place procedures for implementing QDROs, so no new administrative burdens are being placed on the administration of plans.

2. Make it clear that community property rights passing from one spouse to the other which may technically be terminable interests will enjoy QTIP (Qualified Terminable Interest Property) status and obtain a marital deduction for both gift and estate tax purposes.

3 . Make it clear that there is an estate tax on the estate of the nonparticipant spouse and not the participant if the nonparticipant and the participant agree to allow the community property interest of the nonparticipant spouse to pass to third parties on the death of the nonparticipant.

4. Impose income taxes on all alternate payees who are not children or other dependents of a participant and continue to tax a participant for amounts paid to children or other dependents.

One objection to the proposals might be a possible circumvention of the 15% penalty tax imposed by Section 4980A. Section 4980A imposes a 15% excess retirement accumulation tax on large retirement accumulations which are not distributed before the death of the participant. If the participant's spouse is allowed to distribute one-half of a large retirement account, the amount of retirement funds which would be subject to a possible excess accumulation penalty tax could be reduced to such an extent that there would be no excess accumulation penalty tax. For example, if the community property of Harry and Sally includes a $2,000,000 balance in Harry's profit sharing account and if Sally dies first, her $1,000,000 share could pass to her mother and children without:the imposition of a penalty tax. Of course that sum of money would probably be subject to estate tax rates of 40-55% and to income tax rates of 28-39.6%, so the effective over all tax rate on every dollar in the account would still be over 50%. Substantial tax revenues would still be produced for the government. Indeed, if Sally were an under 70 1/2 career woman with $1,000,000 in a profit sharing account, there would be no excess accumulation penalty tax upon her death. As a homemaker, Sally should not bear a heavier burden than the career woman on the exact same amount of money passed on to relatives. Under the proposals of the task force, Sally's one-half community property interest would not bear a heavier tax burden. The two taxpayers would be treated the same.

The Task Force believes that total preemption of community property rights is inconsistent with public policy. The recognition of community property rights is very important to persons residing in community property states and the members of the Task Force wish to do everything possible to obtain appropriate recognition of community property rights in qualified plans and IRAs.

Moreover, as Professor Lawrence W. Waggoner states in his work on spousal rights in our multiple-marriage society, the community property system is much more equitable and fair to both spouses than any other system of marital rights.[19] He concludes that ERISA preemption will stifle advancements in state probate and non-probate law without providing any compensating federal rule.[20] The entire Task Force agrees with Professor Waggoner's assessment of such preemption and has developed its proposals to remedy the problems in the current law.

The actual proposals approved by a majority of Task Force members are included as Appendix A to this article. An exemplar QDRO prepared by Jan Webster of Pillsbury Madison and Sutro in San Diego is included as Appendix B.

APPENDIX A

The proposals will seek to clarify the income tax and qualification issues by recommending changes to current law as follows:

1. Change IRC § 402(e)(1)(A) to read as follows:

> For purposes of subsection (a) and section (72), an alternate payee other than a child or other dependent of the participant shall be treated as the distributee of any distribution or payment made to such alternate payee under a qualified domestic relations order as defined in section 414(p).

COMMENT: This proposed change will impose the income tax on the payee except in the case of child or dependent of the participant. In that case, policy dictates that the tax be paid by the participant. Since the tax consequences of receiving retirement benefits should be consistent with the economic consequences, a beneficiary (other than a child or other dependent of the participant) who receives the benefit should be required to bear the tax. If the beneficiary is a child or other dependent of the participant, tax policy imposes such tax upon the participant responsible for the support of the child or other dependent. Our proposals will not change this current tax treatment of the parties.

2. Change IRC § 408(g) to read as follows:

> For purposes of subsections 408(a)(1), 408(a)(5) and 408(a)(6) and where otherwise specifically required by the Code, this section shall be applied without reference to any community property laws.

COMMENT: This change clarifies the intent not to preempt all community property rights. As discussed in Private Letter Ruling 8040101, this provision applies only to the deduction provisions under sections 219 and 220 of the Code and does not apply to division of a community property interest in an IRA upon divorce or death. Therefore, since the classification of IRAs as community property is a matter of state law, one half of a community property IRA may pass to the legatees of the spouse of the holder on the death of the spouse, and the income will be taxed to the distributee.

3. Change IRC § 414(p)(1)(B)(i) and (ii) to read as follows:
(B) DOMESTIC RELATIONS ORDER. The term "domestic relations order" means any judgment, decree, or order (including approval of a property settlement agreement) which:

(i) relates to provisions for payment of child support, alimony payments, or marital property rights to a spouse, former spouse, child, or other dependent of a participant, or to the estate, heir, legatee, beneficiary of any such participant, spouse, child or dependant, or to a trustee for one of the foregoing.

(ii) is made pursuant to a state law (including community property laws) relating to rights at the death of either spouse or upon divorce. Such order may be a state court order approving a written agreement between a participant and a nonparticipant spouse allowing the nonparticipant spouse to pass his or her community property interest in a qualified retirement plan to a beneficiary other than the participant. In the case of the death of the spouse of the individual for whose benefit the account is maintained, any such order shall be effective as a QDRO only if it is issued and delivered to the Plan Administrator within eighteen (18) months after the date of death of the spouse of the participant.

COMMENT: In order to allow the recognition of community property rights in an area which does not conflict with any federal tax or social policy, this change will allow couples in a community property state to make agreements recognizing their community property rights in qualified retirement plans and to allow courts in community property states to recognize such agreements. In order to ensure that no spouse will ever be deprived of federally protected retirement benefits, the proposed changes will require a written agreement between the spouses before there can be any effect upon the retirement rights of either spouse.

The proposed legislation contains procedures to protect the plan administrators of retirement plans from any new burdens. Plan administrators will not be required to recognize any attempted transfer of community property rights without a state court order which meets all of the qualifications required of a qualified domestic relations order (QDRO). This will ensure that the current administration of plans and IRA's will not be disrupted by burdensome new procedures. Plan administrators already have in place procedures for implementing QDROs, so no new administrative burdens are being placed on the administration of plans.

4. Change IRC §414(p)(8) to read as follows:
(8) ALTERNATE PAYEE DEFINED. The term "alternate payee" means any spouse, former spouse, child, other dependent of a participant, or the estate, heir, legatee or beneficiary of any of the foregoing persons or a trustee for the benefit of any of the foregoing persons which is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such person.

COMMENT: This change is to include the estate, heir, beneficiary, legatee or trustee as an alternate payee.

5. Change ERISA § 206(d)(3)(B) to read as follows:
(B) For purposes of this paragraph:
(i) the term "qualified domestic relations order" means a domestic relations order:
(I) which creates or recognizes the existence of an alternate payee's right to, or assigns to an alternative payee the right to, receive all or a portion of the benefits payable with respect to a participant under a plan, and
(II) with respect to which the requirements of subparagraphs (C) and (D) are met, and (ii) the term "domestic relations order" means any judgment, decree, or order (including approval of a property settlement agreement) which:

(I) relates to the provisions for payment of child support, alimony payments, or marital property rights to a spouse, former spouse, child, other dependent of a participant, or to the estate, heir, legatee or beneficiary of any such deceased participant, spouse, child or dependent or to a trustee for one of the foregoing.
(II) is made pursuant to a state law (including community property laws) relating to rights at the death of either spouse or upon divorce. Such order may be a state court order approving a written agreement between a participant and a nonparticipant spouse allowing the nonparticipant spouse to pass his or her community property interest in a qualified retirement plan to a beneficiary other than the participant. In the case of the death of the spouse of the individual for whose benefit the account is maintained, any such state court order shall be effective as a QDRO only if it is issued and delivered to the Plan Administrator within eighteen (18) months after the date of death of the spouse of the participant.

COMMENT: This change is to expand the definition of a QDRO as explained in the Comment to the recommended change to IRC 414(p)(1)(B)(i) and (ii).

6. Change ERISA § 206(d)(3)(K) to read as follows:
(K) The term "alternate payee" means any spouse, former spouse, child, or dependent of a participant or the estate, heir, legatee or beneficiary of any of the foregoing persons, or a trustee for the benefit of any of the foregoing persons which is recognized by a domestic relations order as having a right to receive all, or a portion of, the benefits payable under a plan with respect to such person.

COMMENT: This change is to expand the definition of alternate payee to include the beneficiaries of the spouse when appropriate as explained in the comment to the recommended change to IRC 414(p)(1)(B)(i) and (ii).

7. Change IRC § 2056(b) (7) (D) to read as follows:
(D) CERTAIN INTERESTS CREATED BY COMMUNITY PROPERTY LAWS. In the case of an employee on whose behalf contributions or payments were made by his

employer or former employer under a trust or plan described in subparagraph (1) or (2), or toward the purchase of a contract described in paragraph (3), or made by an individual or his employer to his individual retirement account or annuity, or simplified employee pension, as defined by the provisions of section 408, if the spouse of such employee predeceases him, then, notwithstanding the provisions of this section or of any other provision of law, the value of any interest of such spouse in such trust, plan, contract, account, or annuity shall be considered as passing from the decedent to the participant except for any portion which such decedent has otherwise expressly transferred to a person or persons other than the participant, to the extent such interest:

(i) is attributable to such contributions or payments, and

(ii) arises solely by reason of such nonparticipant spouse's community property interest in such trust, plan, contract, account or annuity under community property laws of a State.

The interest of a decedent spouse which is described in this subsection:

(A) shall be treated as a qualifying income interest for life, and

(B) the executor shall be treated as having made an election under subsection 2056(b)(7) with respect to such interest unless the executor otherwise elects on the return of tax imposed by section 2001.

A decedent's interest in a plan, trust, or contract is entitled to the deduction provided for in this subsection if it is described below:

(1) An employee's trust (or under a contract purchased by an employee's trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of the decedent's separation from employment (whether by death or otherwise), or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) A retirement annuity contract purchased by an employer (and not by an employer's trust) pursuant to a plan which at the time decedent's separation from employment (by death or otherwise), or at the time of termination of the plan if earlier, was a plan described in section 403(a);

(3) A retirement annuity contract purchased for an employee by an employer which is an organization referred to in section 170(b)(1)(A)(ii) or (iv) or which is a religious organization (other than a trust), and which is exempt from tax under section 501(a), or which is a plan or governmental unit described in section 818(a)(6); and

(4) A trust, account, or plan is an individual retirement account which meets the requirements of 408(a), an individual retirement annuity which meets the requirements of 408(b) or a simplified employee pension plan which meets the requirements of 408(c).

COMMENT: This change is to clarify that a surviving spouse who receives a qualifying interest in a plan qualified under section 401(a), in a retirement annuity contract under section 403, in a retirement annuity contract issued pursuant to a charitable, religious or governmental plan, in an individual retirement account under 408(a), an individual retirement annuity under 408(b) or a simplified employer plan under 408(c) is entitled to a marital deduction. The proposal will also clarify that estate tax may be imposed if a third party other than the spouse directly receives some of the benefits as a result of a transfer to such third party by the participant's spouse.

8. Change IRC § 2523(f)(7) to read as follows:

(7) CERTAIN INTERESTS CREATED BY COMMUNITY PROPERTY LAWS. In the case of an employee on whose behalf contributions or payments were made by his employer or former employer under a trust or plan described in subparagraph (1) or (2), or toward the purchase of a contract described in paragraph (3), or made by an individual or his employer to his individual retirement account or annuity, or simplified employee pension, as defined by the provisions of section 408, if the spouse of such employee makes an irrevocable waiver, consent or transfer of such spouse's community property interest during such spouse's lifetime, then, notwithstanding the provisions of this section or of any other provision of law, the value of any community property interest of such spouse in such trust, plan, contract, account, or annuity shall be considered as passing from the spouse to the participant except for any portion which such participant's spouse has otherwise expressly transferred to a person or persons other than the participant, to the extent such interest:

(i) is attributable to such contributions or payments, and

(ii) arises solely by reason of such spouse's community property interest in such trust, plan, contract, account or annuity under community property laws of a State.

The interest of a participant's spouse which is described in this subsection:

(A) shall be treated as a qualifying income interest for life, and

(B) the participant shall be treated as having made an election under subsection 2523(f)(4) with respect to such interest unless the participant otherwise elects on the return of tax imposed by section 2501.

A spouse's interest in a plan, trust, or contract is entitled to the deduction provided for in this subsection if it is described below:

(1) An employee's trust (or under a contract purchased by an employee's trust) forming part of a pension, stock bonus, or profit-sharing plan which, at the time of the decedent's separation from employment (whether by death or otherwise), or at the time of termination of the plan if earlier, met the requirements of section 401(a);

(2) A retirement annuity contract purchased by an employer (and not by an employer's trust) pursuant to a plan which at the time of transfer, or at the time of termination of the plan if earlier, was a plan described in section 403(a);

(3) A retirement annuity contract purchased for an employee by an employer which is an organization referred

to in section 170(b)(1)(A)(ii) or (iv) or which is a religious organization (other than a trust), and which is exempt from tax under section 501(a), or which is a plan or governmental unit described in section 818(a)(6); and

(4) A trust, account, or plan is an individual retirement account which meets the requirements of section 408(a), an individual retirement annuity which meets the requirements of section 408(b) or a simplified employee pension plan which meets the requirements of section 408(c).

COMMENT: This change is to clarify that a nonparticipant spouse who makes an irrevocable transfer of his or her community property interest in a plan qualified under section 401(a), in a retirement annuity contract under section 403, in a retirement annuity contract issued pursuant to a charitable, religious or governmental plan, in an individual retirement account under section 408(a), an individual retirement annuity under section 408(b) or a simplified employer plan under section 408(c) to his or her spouse is entitled to a marital deduction even if the transfer is a terminable interest. The proposal will also clarify that gift tax may be imposed if the transferor's spouse does not have an interest in the benefit subject to the transfer.

CONCLUSION

None of the proposals will cause the disruption of any present policies protecting the rights of spouses of participants in qualified retirement plans. Nor will the changes cause any shift of tax obligations away from the responsible persons. The recommendations recognize the community property rights of married persons who have a written agreement establishing their intentions in this regard and ensure that the tax and regulatory effects will coincide with the economic and ownership rights of the parties.

APPENDIX B

Attorney's Name
Name of Law Firm
Address:

DRAFT QDRO PROVISIONS[21]
For award of Community Prpoerty Interest
in a Consenting Participant's
401(k) Plan Benefits
to Estate, Heir etc. of Nonparticipant Spuose

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF ______________________

In re: ______________________, deceased.

Case No. ____________

STIPULATED QUALIFIED DOMESTIC RELATIONS ORDER

Petitioner, ____________, and Respondent, ________________, and the Apple, Inc. 401(k) Savings Plan ("Plan") hereby stipulate as follows:

RECITALS

1. [Name of nonparticipant spouse] ("Nonparticipant Spouse") and Respondent were married to each other on _____________. Nonparticipant Spouse died on _______________.

2. On [date] Respondent and the Nonparticipant Spouse consented in writing to allow the Nonparticipant Spouse to pass [his/her] community property interest in the Plan to Petitioner pursuant to Section 5011 of the California Probate Code. A copy of such consent is attached hereto as Exhibit "A" and incorporated herein by reference.

3. As of [date of Nonparticipant Spouse's death], neither Participant nor the Nonparticipant Spouse had modified or otherwise revoked the terms of Exhibit A.

4. This Court has personal jurisdiction over both Petitioner and Respondent and jurisdiction over the subject matter of this Order.

STIPULATION

This Order is a "qualified domestic relations order" ("QDRO") as that term is used in section 206(d)(3) of the Employee Retirement Income Security Act of 1974, as amended ("ERISA") and section 401(a)(13)(B) of the Internal Revenue Code of 1986, as amended ("Code").

IT IS HEREBY ORDERED BY THE COURT THAT:

1. This Order is entered pursuant to Section [section number] of the California Probate Code.

2. Respondent ("Participant") earned certain benefits under the Plan ("Plan Benefit") that are the community property of Participant and the now-deceased Nonparticipant Spouse.

3. As of the date of the Nonparticipant Spouse's death, the community interest of Participant and the Nonparticipant Spouse in Participant's Plan Benefit was [100/___] percent and was invested as follows: _____% in Fund A, _____% in Fund B, _____% in Fund C, _____% in Fund D, _____% in Fund E, _____% in Fund F and _____% in Fund G.

4. The Court awards Petitioner ("Alternate Payee") [50/___] percent of the community interest in [each of the Funds in which Participant's Plan benefit is invested/or specify Funds].

5. Alternative Payee's interest in Participant's Plan Benefit ("Plan Interest") is currently invested as shown below and the value of Alternate Payee's Plan Interest as of _____________ (the Valuation Date (defined in the Plan) immediately preceding the Nonparticipant Spouse's death) was as follows:

Fund A -	Fixed Investment Fund	$______
Fund B -	Washington Capital Management Conservative Equity Option	$______
Fund C -	Washington Capital Management Aggressive Equity Option	$______
Fund D -	Vanguard Wellesley Income Fund	$______
Fund E -	Vanguard Star Fund	$______
Fund F -	Vanguard Index Fund	$______

Fund G -	Vanguard PRIMECAP Fund	$______
	Total:	$______

6. The value of Alternate Payee's Plan Interest as of the most recent Valuation Date (______) was as follows:

Fund A -	Fixed Investment Fund	$______
Fund B -	Washington Capital Management Conservative Equity Option	$______
Fund C -	Washington Capital Management Aggressive Equity Option	$______
Fund D -	Vanguard Wellesley Income Fund	$______
Fund E -	Vanguard Star Fund	$______
Fund F -	Vanguard Index Fund	$______
Fund G -	Vanguard PRIMECAP Fund	$______
	Total:	$______

7. From and after the date of this Judgment and until the effective date Alternate Payee's Plan Interest is distributed from the Plan:

(a) Alternate Payee's Plan Interest shall be accounted for under a separate Plan account established on behalf of Alternate Payee;

(b) Alternate Payee may direct and manage the investment of [his/her/its] Plan Interest in Funds A through G in accordance with the terms of the Plan and the Plan's Summary Plan Description on and after the date the Plan Administrator determines that this Order is a qualified domestic relations order ("QDRO"); provided, however, that Alternate Payee's Plan Interest shall remain invested as shown in Paragraph 6 above if Alternate Payee does not exercise [his/her/its] right to direct and manage the investment of Alternate Payee's Plan Interest;

(c) Alternate Payee shall not be entitled to borrow or make withdrawals from (his/her/its] Plan account or to contribute to the Plan; and

(d) Alternate Payee's Plan Interest shall be adjusted to reflect any changes in the investment vehicles and any increases or decreases in value from (date of Nonparticipant Spouse's death] to the Valuation Date immediately preceding the date Alternate Payee's Plan Interest is distributed.

8. Alternate Payee may elect to have distribution of [his/her/its] Plan Interest, as adjusted, made on any date after the date the Plan Administrator determines that this Order is a QDRO, provided that the following conditions and limitations are met:

(a) The date of the distribution to Alternate Payee is not later than the date the Participant begins receiving [his/her] Plan Benefit;

(b) Alternate Payee files with the Human Resources or Corporate Benefits Department on the prescribed form a written application for distribution of [his/her/its] Plan Interest; and

(c) Alternate Payee provides the Plan with whatever information the Plan Administrator reasonably needs to determine the amount of Alternate Payee's Plan Interest.

9. Participant shall cooperate fully with Alternate Payee and the Plan to enable them to carry out the conditions of this Order.

10. Subject to the provisions of Paragraph 8, Alternate Payee's Plan Interest, as adjusted, shall be distributed to Alternate Payee in a single lump sum as soon as reasonably practicable after the Valuation Date preceding the date elected for distribution by Alternate Payee.

11. When Participant's Plan Benefit is to be paid to [him/her], the Plan shall pay to Participant the balances remaining in [his/her] various Plan accounts reduced by Alternate Payee's Plan Interest, as adjusted pursuant to Paragraph 7(d).

12. [Note, this paragraph only applies where the Alternate Payee is an individual.] If Alternate Payee dies before the date [he/she] receives or commences to receive [his/her] Plan Interest, the Plan shall pay her Plan Interest to the surviving beneficiary designated by Alternate Payee in accordance with the terms of the Plan; provided, however, that if a designated beneficiary does not survive Alternate Payee or if Alternate Payee fails to designate a beneficiary, the Plan shall pay Alternate Payee's Plan Interest to Alternate Payee's estate.

13. *Participant's Name*. Participant's name, current mailing address and Social Security number are:

____
____
_____-_____-_____.

Participant shall keep the Plan advised at all times of [his/her] current mailing address.

14. *Alternate Payee's Name*. Alternative Payee's name, current mailing address and Social Security number are:

____
____
_____-_____-_____.

Alternate Payee shall keep the Plan advised at all times of [his/her/its] current mailing address.

15. This Order shall be administered and interpreted in conformity with ERISA and the Code. If ERISA or the Code is amended or the law regarding QDROs is otherwise changed or modified, then the parties hereto shall immediately take the steps necessary to amend this Order to comply with any such changes, amendments and/or modifications, or, if permissible under any such change, amendment, or modification to ERISA or the Code or laws regarding QDROs, the Plan Administrator may treat this order as a QDRO.

16. The Court shall retain jurisdiction over this matter to in order to establish and/or maintain its qualification as a QDRO under ERISA and the Code.

IT IS SO STIPULATED:

[name of law firm]

By ______________________
[name of attorney]
Attorney for Petitioner

[name of law firm]

By ____________________
[name of attorney]
Attorney for Respondent

APPLE, INC. 401(k) SAVINGS PLAN

By ____________________
[name of individual signing for Plan Administrator]
Plan Administrator

THE CLERK IS ORDERED TO ENTER THIS ORDER

DATED: ____________ ________________________
JUDGE OF THE SUPERIOR COURT

END NOTES

1. The comments contained in this paper are the individual views of the author(s) who prepared them, and do not represent the position of the State Bar of California or of the Los Angeles County Bar Association.

2. *Acknowledgements.* The author acknowledges with appreciation the assistance provided by Colleen Casey of Losey & Casey, San Francisco, California; Judd Martin of Lesourde & Patten, Seattle, Washington; Edward F. Martin of Jones, Walker, Waechter, Poitevent, Carrere & Denegree, New Orleans, Louisiana; Kent McMahan and Diane Perrin of Fulbright & Jaworski, Houston, Texas; Louis A. Mezzullo, Mezzullo & McCandlish, Richmond, Virginia; John L. McDonnell and Betty J. Orvell of Crosby, Heafey, Roach & May, Oakland, California; Cecil A. Ray Jr., Dallas, Texas; Lee A. Trucker of Trucker, Hess, Klamm & Saks, San Francisco, California; Marcia Chadwick Holt, Davis, Graham & Stubbs, Denver, Colorado; Jan Webster of Pillsbury Madison & Sutro, San Diego, California; Janet L. Wright, Fresno, California; Alfred J. Olsen of Olsen/Smith Ltd., Phoenix, Arizona; Paul Gordon Hoffman of Hoffman, Sabban & Brucker, Los Angeles, California; Kim Stanley of Gray, Cary, Ames & Frye, San Diego, California; Steven L. Guise of Munger Tolles & Olson, Los Angeles, California; C. Royda Crossland of Parker & Crossland, Larkspur, California.

3. Wagoner, *Marital Property Rights in Transition*, 18 The Prob. Law. 1, 6 (1992).

4. This task force is composed of representatives from bar association groups in Louisiana, Texas, Arizona, Washington and California. Among the groups are members appointed by the Real Property Probate, and Trust Law Section of the American Bar Association; the Employee Benefits Committee of the Taxation Section of the California Bar Association; the Estate and Gift Tax Committee of the Taxation Section of the California Bar Association; the Taxation Section of the Arizona Bar Association; the Employee Benefits Committee of the American College of Trusts & Estates Counsel; the Executive Committee of the Probate, Estate Planning and Trust Law Section of the California Bar; The Texas Academy of Probate and Trust Lawyers; and the Probate and Trust Law Section of the Washington State Bar Association.

5. Pub. L. No. 93-406, 88 Stat. 829 (1974).

6. Pub. L. No. 98-397, 98 Stat. 1426 (1984).

7. *See* Priv. Ltr. Rul. 8125097 (Mar. 26, 1981); Priv. Ltr. Rul. 8027041 (Apr. 9, 1980); Priv. Ltr. Rul. 8025049 (Mar. 25, 1980); Priv. Ltr. Rul. 7952045 (Sept. 25, 1979).

8. 937 F.2d 1450 (9th Cir. 1991).

9. *Id.* at 1453.

10. *Id.* at 1457.

11. 439 U.S. 572, 581-83 (1973) (citation omitted.)

12. 937 F.2d at 1462 (Fletcher, J., dissenting).

13. *Id.* at 1468.

14. *Id.* (fn. omitted).

15. *Id.*

16. Cal. Prob. Code §§ 5002-5032 (West Supp. 1993).

17. Pub. L. No. 98-369, 98 Stat. 494 (1984).

18. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

19. Waggoner, *Spousal Rights In Our Multiple-Marriage Society: The Revised Uniform Probate Code*, 26 Real Prop. Prob. & Tr. J. 683, 717-25 (1992).

20. *Id.* at 697.

21. These provisions reflect California law and may need to be revised to accommodate other state laws.

APPALACHIAN MOUNTAIN CLUB
FIVE JOY STREET BOSTON, MASSACHUSETTS 02108 617-523-0636

Testimony before the House Ways and Means Subcommittee on Select Revenue Measures,
on the Rural Land Conservation Act

Jennifer Melville, Conservation Director
Appalachian Mountain Club
June 24, 1993

Chairman Rangel and Members of the Committee, thank you for this opportunity to provide you with comments today. The Appalachian Mountain Club (AMC), the nation's oldest conservation and recreation organization, endorses the proposal to exclude from a gross estate the value of land subject to a permanent conservation easement. The AMC urges the Committee to support this proposal, which is embodied in the Rural Land Conservation Act of 1993, HR 2031.

Our nation is losing over four square miles of critical land to development every day. Passage of the Rural Lands Conservation Act would help to reverse this trend by conserving many hundreds of thousands of acres of privately-owned forests, farmland, wildlife habitat and essential open space. Further, enactment of this proposal will ensure that valuable conservation lands are protected without expending large sums for land acquisition or management and without imposing any new land use regulations.

The AMC is greatly concerned about the land fragmentation and development - and the resulting loss of ecologically and recreationally important land - that can ensue from large estate tax burdens. In AMC's work in the northeast, we have come across numerous instances where conservation-minded land owners face difficult choices about the future of their land. Such landowners must often choose between one of two poor options: selling their land for development to ease their heirs' future estate tax burden, or leaving their land to their children who will themselves be forced to sell their land. HR 2031 would provide a third, and far preferable alternative to these landowners and to the nation.

We urge the Committee to support this important tax provision, which has great implications for land conservation in the Northeast, as well as the entire nation. On behalf of our 55,000 members, thank you for working to ensure passage of this critical tax proposal and thank you for this opportunity to provide testimony.

APPALACHIAN TRAIL
CONFERENCE
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Statement By: John Stokes, Administrator
Trust for Appalachian Trail Lands
A program of the Appalachian Trail Conference

For: Hearing before the Ways and Means Committee,
Select Revenue Measures Subcommittee

Regarding: The proposal to exclude from a gross estate the value of land subject to a permanent conservation easement.

Date: June 24, 1993

The Appalachian Trail Conference supports H.R. 2031, a proposal to exclude from a gross estate the value of land subject to a permanent conservation easement. The Conference is a private, nonprofit educational organization composed of approximately 24,000 members as well as 60 hiking and outing clubs representing an estimated 70,000 individuals. Since 1925, the Conference has coordinated private efforts to develop, maintain, and preserve the Appalachian Trail for the benefit of millions of Americans.

The Appalachian Trail is a continuous, marked footpath that traverses the Appalachian mountain chain from Maine to Georgia for 2,147 miles. The Trail provides a slender thread linking more than 200 communities and 60 public land areas in 14 states. To date, after a half-century of federal, state, and private efforts, only about 50 miles of the Trail remain unprotected. The Appalachian Trail Conference now estimates that the U.S. Forest Service will complete its Appalachian Trail land-acquisition and protection program by the end of 1994 or 1995, while the National Park Service will complete its program by 1997.

In 1982, the Conference created the Trust for Appalachian Trail Lands to complement public protection of the Trail corridor. In part, the Trust was established because there were concerns in the Trail community that the narrow Trail corridor, while providing a basic level of protection, would not encompass numerous agricultural, natural, historic, and scenic features that are an integral part of the Appalachian countryside.

Today, the Trust has become one of the leading nonprofit land conservancies in the country and has helped protect more than 12,000 acres of land associated with the Trail. Presently, the Trust is engaged in a variety of acquisition projects, neighborhood greenway projects, and land-planning endeavors. And, as federal programs to protect the Trail are completed within the next few years, the Trust will play an increasingly important role in the private effort to preserve the broader landscape that composes the Appalachian countryside.

To conclude, in view of the growing importance of voluntary, private efforts to preserve and protect rural lands throughout the United States and, more particularly, near the Appalachian Trail,

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Paul R. Worsham

David N. Startzell
Executive Director

A Volunteer Nonprofit Corporation Responsible for Management and Protection of the Appalachian Trail • Founded in 1925

the Appalachian Trail Conference is submitting this statement in support of the proposal to exclude from a gross estate the value of land subject to a permanent conservation easement. This proposal would provide an important new incentive for voluntary land conservation which could be of significant value to many citizens. The exclusion would provide a powerful incentive to "land rich/cash poor" landowners who desire to conserve their land for future generations, but cannot take advantage of current tax benefits. By removing the estate tax burden, and subjecting property to a qualified conservation easement, a strong incentive is created to maintain land in agricultural production or as open space.

Respectfully,

John Stokes
Administrator
Trust for Appalachian Trail Lands

David N. Startzell
Executive Director
Appalachian Trail Conference

The Brandywine Conservancy, a major conservation organization devoted to the preservation of water resources and open space in the Brandywine River Valley and elsewhere, strongly supports the Rural Land Conservation Act of 1993, H.R. 2031. This Act is a proposal to exclude from a gross estate the value of land subject to a permanent conservation easement. Of course, this Act relates to estate and gift taxation.

While we understand that the bill will require some technical modification and correction, we support its substance. The bill will greatly encourage private conservation efforts resulting in the protection of large areas of land vital to the quantity and quality of water supplies. No public effort at such protection could be as important as the rapid accumulation in the near future of conservation easements on strategic watershed lands. This bill will serve as a major impetus to landowners to contribute conservation easements.

The Brandywine Conservancy has placed more than 24,000 acres of land in conservation easements. We believe that with this effort we have only begun essential preservation of water resources for hundreds of thousands of people in this region. We urge your support of H.R. 2031 which will provide a new and vital tool for this organization and many other responsible conservation groups.

George A. Weymouth, Chairman
Brandywine Conservancy

Chesapeake Bay Foundation

Environmental Defense - Environmental Education - Land Management

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HONORARY TRUSTEES
T Marshall Duer Jr
C A Porter Hopkins
Charles McC Mathias
Sture G Olsson
C Trowbridge Strong
William W Warner

Joseph H Maroon
Virginia Executive Director

Jane T Nishida
Maryland Executive Director

Robert G Hoyt
Pennsylvania Executive Director

June 18, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

I am writing to express the support of the Chesapeake Bay Foundation for the Rural Land Conservation Act of 1993.

The Chesapeake Bay region has in the recent past seen dramatic declines in the amount of rural acreage. Experts predict that this decline will continue as an ever-increasing population consumes more and more land. This decline is not without environmental and economic consequences. The water quality of the Bay suffers as we convert forests to blacktop and shopping malls; meanwhile, local infrastructure costs soar as farms become subdivisions.

The Rural Land Conservation Act of 1993 will help slow this decline by increasing the incentives for individual voluntary land preservation actions. Through the creation of conservation easements, landowners can make an important and long term commitment to rural land preservation and environmental and economic health. The Rural Land Conservation Act of 1993, by changing the tax provisions regarding estates containing land encumbered by a conservation easement, encourages individual commitment to land conservation.

We would appreciate your active support of the Rural Land Conservation Act and would be glad to respond to any questions you may have.

Sincerely,

William C. Baker
President

cc: E. Thomas
M. Hirshfield
J. Maroon

TO: MEMBERS OF THE SELECT REVENUE MEASURES SUBCOMMITTEE OF THE WAYS AND MEANS COMMITTEE

FROM: IRA STERN, EXECUTIVE DIRECTOR, DUTCHESS LAND CONSERVANCY

As the director of a non-profit land preservation organization in the rural Hudson Valley of New York, I have the opportunity to speak with the owners of open farm and forest land daily. Protecting land is ultimately an economic decision and it is imperative that the opportunities for protecting privately owned land for the benefit of the public be available to all.

The Rural Land Conservation Act of 1993 accomplishes this. This proposal would exclude the value of land subject to a permanent conservation easement from a decedent's estate. High estate taxes are one of the primary reasons our open land resources are being developed. Too many families have unwittingly left their land to their children only to have them lose the place where they grew up, selling it to pay the estate taxes.

Conservation easements have served the nation well keeping important natural land in private hands and on the tax rolls. This is important because the taxpayers do not have to foot the management bill for the open land and revenues continue to be generated. Currently, the only financial incentive for a private landowner to give a conservation easement away would be a Federal income tax deduction for the value of the land restricted by the easement. Tax deductions are of value only to those landowners with the income to shelter. For the land-rich/cash-poor landowner, the deductions are worthless. That landowner can only sit around dreading the effect estate taxes will have on his children's ability to keep the family land while watching his wealthier neighbors reap significant tax savings for protecting their land.

The Rural Land Conservation Act of 1993 would even the playing field for private landowners interested in protecting their land. It would dramatically increase the amount of privately protected land in the United States and insure that our natural heritage will continue at no cost to the taxpayer.

STATEMENT OF
JEAN W. HOCKER, PRESIDENT
LAND TRUST ALLIANCE

SUBMITTED TO THE

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES

Hearings on Miscellaneous Revenue Measures
Week of June 21, 1993

regarding

**a proposal to exclude from a gross estate
the value of land subject to a permanent conservation easement**

Mr. Chairman and members of the Subcommittee, I am pleased to submit testimony on this critical issue, which directly affects the conservation of endangered open lands.

I am President of the Land Trust Alliance, a national membership organization serving the nation's nearly 1,000 local and regional land trusts. We strongly support the proposal to exclude the value of land subject to a permanent conservation from a decedent's gross estate. This proposal, if enacted into law, will protect, by voluntary means, some of the most severely threatened productive and ecologically fragile land in our country, at a cost to the public of a small fraction of its fair market value, all while keeping the land in private ownership and on local tax rolls.

Land trusts are nonprofit, tax-exempt land conservation organizations, operating principally at the local or regional levels. They protect natural areas, agricultural land, habitat, wetlands, greenways, urban gardens, recreational properties, and other kinds of conservation land for the public benefit. Local and regional land trusts, now numbering nearly 1,000 and operating in every state, have helped save over 3 million acres of irreplaceable open land. They have attracted nearly a million members.

One of the principal ways land trusts protect land is by working with landowners to design and accept conservation easements. Under such an easement, the landowner, by means of a recorded legal instrument, permanently gives up rights to use the land in specific delineated ways that would harm its conservation resources. The holder of the easement, usually a land trust or public resource agency, agrees to monitor and enforce the terms of the easement. The land remains in private ownership and in productive use, but the restrictions are usually perpetual, binding all future owners.

Conservation easements typically limit the kind and amount of development that can take place on the property. Depending on the resources to be protected, it may also restrict such uses as disturbing a stream bank, blocking a migration route, or degrading water quality. The conservation easement is entirely a voluntary agreement, and is usually donated to the recipient. It is an excellent tool for protecting many kinds of land, because only those uses that would harm conservation resources need be restricted; the easement can be tailored specifically for each property to be protected.

A conservation easement must meet the tests of public benefit in order to qualify as a tax-deductible charitable gift. The Treasury regulations that govern the deductibility of conservation easements are extremely detailed and rigorous. The result is that qualified conservation easements provide significant conservation benefit to the public.

Many landowners, however, are hesitant to protect their land in this way, because of the substantial loss of monetary value that usually results from restricting development. Landowners who are cash-poor are especially hesitant. Not only do they lose immediate value; they fear that their heirs may be forced to sell the family farm or ecologically-fragile property anyway, to pay the estate taxes due. Such a forced sale is usually for development. The result is yet more acres of scarce open land converted to shopping strips or subdivisions.

The proposal you are considering would go far to alleviate these concerns and encourage owners of endangered open land near urban areas, as well as owners of sensitive land near National Parks and Wilderness Areas, to protect their land through permanent conservation easements. At a time when public dollars for land acquisition are shrinking and regulatory measures encounter increasing opposition, the permanent, voluntary measures encouraged by this proposal are timely and critical for the future of endangered open space.

I wish to strongly emphasize the need for a related provision contained in this proposal. H.R. 2031 also would amend Section 170(h)(5)(B) of the Internal Revenue Code (relating to charitable donations of "qualified conservation contributions") to permit deductible donations of conservation easements on land where the mineral estate has been severed from the surface estate, without regard to the date of severance, as long as the likelihood of surface extraction of minerals is so remote as to be negligible.

Current law requires that the severance have taken place prior to June 13, 1976, in order for a split estate property to meet the test of a qualified conservation easement. There are now many critical conservation properties whose owners are ready and eager to donate conservation easements to permanently protect their land and on which the likelihood of surface extraction is negligible. But because the mineral and surface rights were severed after June 13, 1976, they cannot donate a tax-deductible easement. In many parts of the country it is common for sellers to retain mineral rights when selling the land, not because there are necessarily valuable minerals to be had, but merely because it is the custom. Protection of these properties through voluntary easements will be forever denied to the public until and unless the 1976 date is deleted from the law. We urge you to make this change as quickly as possible.

The Land Trust Alliance has considerable experience with conservation easements. We have produced many books, articles, and workshops on operating sound easement programs and many of our land trust members are among the most experienced and successful users anywhere of conservation easements for land protection.

As you proceed to examine this proposal, we will be extremely pleased to provide our assistance and expertise. We urge your early and favorable consideration of this important issue. Every day of delay means the loss of more and more critical open space and a diminution of our nation's heritage.

Thank you.

Oregon Trout, Inc.
5331 SW Macadam, Ste. 228
Portland, OR 97201
(503) 222-9091

To the Members of the Committee on Ways and Means:

I urge support for the proposal to exclude from a gross estate the value of land subject to a permanent conservation easement (part of the "Rural Land Conservation Act of 1993," H.R. 2031). Oregon Trout promotes the health and success of native fish. Land conservation is an important part of this objective, and this legislation would provide a very important new incentive for voluntary land conservation. Devisors or donors of land subject to permanent conservation easements could receive an estate or gift tax reduction if the land is in an area of significant development pressure. This could be a significant benefit to the citizens of Oregon by making it more attractive to devote land to environmental conservation, with minimal cost to the state.

Sincerely,

Geoff Pampush,
Executive Director, Oregon Trout, Inc.

Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington D.C. 20515

Dear Director Mays,

This testimony is submitted on behalf of Save The Bay, a 15,000 member environmental organization dedicated to the preservation of the Narragansett Bay in Rhode Island, in favor of passage of S.1013: THE RURAL LAND CONSERVATION ACT OF 1993.

Everyday the watershed in our Bay area sprouts more parking lots, more roads, more houses, more lawns, more septic systems. Everyday we find it that much harder to keep the water in the Bay fit for human use. The natural filters that cleansed our Bay 100 years ago, are vanishing. The wetlands, the forests, and the meadows all held back, filtered or absorbed pollutants. Today those areas have been cut and paved. Polluted stromwater runs directly from pipes into our rivers and eventually into the Bay. More that 40 percent of the Bay is closed to shellfishing on any rainy day, and more and more of it is being closed every year. We are losing the battle and need all the help we can get. S. 1013 is a tool sorely needed.

This bill would conserve farmland, forest, and ranch, as well as environmentally sensitive land, wildlife habitat, open space and historically significant land under significant development pressure in the vicinity of metropolitan areas and national parks. The Act will do this without regulation or purchase by exempting rural land subject to a permanent conservation easement from the federal estate tax.

On behalf of our 15,000 members we urge you to pass S.1013.

Sincerely,
Curt
Curt Spalding,
Executive Director

WRITTEN STATEMENT ON "A PROPOSAL TO EXCLUDE FROM A GROSS ESTATE THE VALUE OF LAND SUBJECT TO A PERMANENT CONSERVATION EASEMENT"

THE RURAL LAND CONSERVATION ACT OF 1993 (H.R. 2031)
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE
BY
DANA BEACH, EXECUTIVE DIRECTOR
SOUTH CAROLINA COASTAL CONSERVATION LEAGUE

My name is Dana Beach. I am the Executive Director of the South Carolina Coastal Conservation League (SCCCL), located in Charleston, South Carolina. The Conservation League is a non-profit conservation group dedicated to the protection of South Carolina's coastal environment.

SCCCL strongly supports H-2031, The Rural Land Conservation Act of 1993, and urges the Subcommittee on Select Revenue to give this bill favorable consideration.

In recent decades, the South Carolina coast has experienced unprecedented growth pressures. Between 1950 and 1990, the population of the seven principal coastal counties grew from 364,000 to 886,000 -- a 143 percent increase. During this same period, population density climbed from 60 persons per square mile to 146 persons per square mile. These trends are expected to continue between 1990 and 2010, with population levels rising to about 1.4 million, a 45 percent increase in just 20 years.

This growth has brought with it the benefits of economic expansion, but it has also placed many of South Carolina's environmental resources in severe jeopardy. The main casualty has been the indiscriminate and unnecessary use of too much of the State's prime rural land for suburban and resort development. Associated secondary impacts include: the needless destruction of coastal and fresh water wetlands; the diminishment of the rural economy and the Lowcountry landscape; and the impairment of coastal water quality leading to the closure of 40% of the state's shellfish beds.

Fortunately, South Carolinians are becoming increasingly aware of the problems associated with the rapid development of the coastline. In particular, many private landowners are seeking ways to protect their properties from the encroachment of suburban sprawl and resort development. For example, the ACE Basin Initiative serves as a national model for how private landowners, non-profit organizations and government agencies can cooperate to protect a pristine river basin. To date, over 100,000 acres have been permanently protected through purchase and private easements in the Ashepoo-Cumbahee-Edisto River Basin.

But much remains to be done, both in the ACE Basin and in other threatened areas up and down the South Carolina Coast. While many private land owners have a strong desire to permanently protect their land from development and keep these properties in their families, the tax structure works to undermine their best efforts. Property values rise as adjoining properties are developed which raises local property taxes and estate taxes. These increasing tax levies are powerful reasons to do what many property owners would otherwise not do -- sell their land for development. While the federal government cannot control the negative effects of rising property taxes, it can correct the problem the estate tax creates for these individuals.

The Rural Land Conservation Act of 1993, if passed into law, would be an elegant solution to this problem. By allowing an Executor to elect an exclusion from the federal estate tax for land subject to a conservation easement, the federal government would remove one impediment standing in the way of private land owners who wish to permanently protect their land.

The public benefits of this measure would be enormous. It would enable private citizens to help protect important cultural and historic resources, support a working rural economy, preserve the traditional rural landscape, curb the negative environmental effects of sprawl and resort development, and permanently protect wildlife habitat. The beauty of the proposed legislation is that it would accomplish all of these tasks without any additional government regulation.

Since this tax measure would be "revenue neutral," through a slight increase in the general estate tax rate for estates only in excess of $5 million, there is no significant public cost associated with the Rural Land Conservation Act.

Given that the benefits are so great and the costs virtually non-existent, SCCCL strongly urges the Subcommittee to favorably report this H.R. 2031 to the full House Ways and Means Committee. Thank you.

STATEMENT OF
WARD L. QUAAL,
OF
THE WARD L. QUAAL COMPANY
SUBMITTED TO THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 24, 1993

Mr. Chairman, Members of the Subcommittee. I am Ward L. Quaal of The Ward L. Quaal Company. I submit this statement in support of amending the Federal estate tax valuation rules for family-owned media businesses. This proposal is listed as the third proposal under the Estate and Gift tax section of the Subcommittee's press release of June 2, and described on page 74 of the document prepared for these hearings by the staff of the Joint Committee on Taxation.

SUMMARY AND EXPLANATION OF SECTION 2032(B)

Congress, in the Cable Television Consumer Protection and Competition Act of 1992, specifically found, among other things, as follows:

> 1. That the average monthly cable rate has increased almost three times as much as the Consumer Price Index since rate deregulation pursuant to the Cable Communications Policy Act of 1984;
>
> 2. That most cable television subscribers have no opportunity to select between competing cable systems; and that without the presence of another multi-channel video programming distributor, a cable system faces no local competition.
>
> 3. That the cable industry has become highly concentrated, and that such concentration is a barrier to entry for new programmers, thereby reducing the number of media voices available to consumers;
>
> 4. That there is a substantial governmental and First Amendment interest in promoting a diversity of views provided through multiple technology media;
>
> 5. That a primary objective and benefit of our nation's system of regulation of television broadcasting is local origination of programming; and there is a substantial governmental interest in insuring its continuation.

Clearly, it was the intention of Congress to foster competition in the broadcast media area.

In addition, the absorption of closely held family media businesses by large conglomerates has been proceeding at an alarming rate in recent years. Consistent with the policies of Congress enunciated in the Cable Television Act, the preservation of local family media businesses, as an independent voice to which the consumer is entitled to access, can only be enhanced by allowing such family media businesses to quickly and fairly determine the federal estate tax liability attributable to such business on the death of a substantial shareholder.

Recent cases in the courts have created tremendous uncertainty for family owned and controlled media business, where as long as eight to ten years has been spent in negotiation and litigation to determine the value of such business for federal estate tax purposes. Current provisions of the Internal Revenue Code, including Regulations thereto, published Rulings and interpretations thereof by the courts, do not provide an adequate means for determining the fair market value of family owned and controlled media businesses, without the likelihood of protracted and extended litigation, which in and of itself may compromise the ongoing vitality of the family owned and controlled media business.

Finally, in an age of tax and fiscal responsibility, no business, including a family owned and controlled media business, should be absolved from paying its full and fair share of tax liability, including federal estate tax liability imposed on the death of any substantial owner of any such business.

The purpose of proposed Section 2032(B) is to provide a quick and efficient method of determining fair market value, consistent with the provisions of the Internal Revenue Code, and with valuation principles and methodology in the marketplace. The valuation formula in the proposed statute will be a rebuttable presumption for decedents whose federal estate tax returns are due on or after January 1, 1995. Prior to that date, the statutory valuation formula will be binding.

Currently, the overriding principle in the marketplace for valuing media businesses is based on a multiple of net cash provided by operating activities. In the proposed statutory language, a multiple of seven times net cash provided by operating activities will initially be used to value a family owned and controlled media business. Net cash provided by operating activities will be determined for the business from its statement of cash flow (or from its consolidated statements of cash flow for a Holding Company that meets the definition of a family owned and controlled media business), which statement is prepared pursuant to generally accepted accounting principles consistently applied.[1] A valuation multiple of seven is consistent with the current market for media businesses and will reflect fair market value so that the estate of a substantial owner of a closely held family media business will be subject to fair and accurate estate tax on the death of such shareholder. Because multiples will change (and have changed) over time, the valuation formula set forth in the proposed Section 2032(B) will be a rebuttable presumption for decedents whose federal estate tax return is due on or after January 1, 1995. This will assure that, on an ongoing basis, the statute will provide an appropriate framework for determining value and fairly paying estate tax attributable to ownership of a family owned and controlled media business.

Depending on the specific interest in a family owned and controlled media business which is included in the decedent's gross estate, proposed Section 2032(B) would not impact appropriate discounts or premiums for voting v. non-voting shares, as well as discounts for minority interest and lack of marketability. As stated above, all of the foregoing would set an appropriate and efficient framework for determining the value of the closely held family media business, allowing the decedent's estate to pay its fair share of federal estate tax, based on an accurate determination of fair market value, without the great risk of protracted litigation which can last up to a decade, and which can undermine the ongoing activities of the media business. It is believed that the foregoing will allow for the survivorship of closely held media businesses, as an independent voice, less susceptible to acquisition by large conglomerates, thereby increasing the available voices in the marketplace for consumers.

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[1] Net cash provided by operating activities will mean net income or loss as set forth on the Statement of Operations (or Consolidated Statement of Operations) for the fiscal year end immediately preceding the date of decedent's death; increased by depreciation and amortization; decreased by payments for film and program rights and deferred income taxes; and increased or decreased, as the case may be, by equity in income or loss of unconsolidated subsidiaries and/or minority interests in subsidiaries, disposal of equipment, and changes in operating assets and liabilities (limited to accounts and notes receivable, income taxes payable, prepaid expenses and other current assets and accounts payable and accrued expenses) all computed pursuant to generally accepted accounting principles consistently applied.

For these stated reasons, I respectfully request favorable consideration of this important proposal to amend the estate tax valuation rules for family-owned media businesses.

STATEMENT OF THE AMERICAN FARM BUREAU FEDERATION TO THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES REGARDING H.R. 1411

June 24, 1993

The American Farm Bureau Federation, the nation's largest general farm organization representing over four million member families from every state and Puerto Rico, is pleased to support the enactment of H.R. 1411, a bill to amend the Internal Revenue Code of 1986 to double the maximum benefit under the special estate tax valuation rules for certain farm real estate property.

In our 1993 policy developed by the voting delegates at our 74th annual meeting held in Anaheim, California, in January, we state as follows:

> "We support elimination of the $750,000 ceiling allowed in determining the existing exemption under Internal Revenue Code 2032-A for agricultural productive value."

H.R. 1411 would move us substantially closer to our goal of eliminating the current statutory ceiling of $750,000 by doubling that amount to $1,500,000. This will allow prime agricultural land to remain in production and will help ease the inter-generational transfer of family-owned farms and ranches.

We feel this bill is definitely a step in the right direction, and it should be enacted promptly.

Thank you for the opportunity to file this statement.

STATEMENT IN SUPPORT OF CLARIFICATION OF ESTATE TAX SPECIAL USE VALUATION RULE

Hearings on Miscellaneous Revenue Issues
Subcommittee on Select Revenue Measures
House Ways and Means Committee
June 24, 1993

Chairman Rangel and Members of the Subcommittee:

We greatly appreciate your willingness to consider the proposal to amend Internal Revenue Code section 2032A to clarify that cash rentals of the property by one qualified heir to a member of that person's family will not cause the loss of special use valuation treatment. In addition, we would like to commend Mr. Grandy and Senator Daschle for their steadfast commitment to enactment of this provision.

SECTION 2032A

Section 2032A was enacted in 1976 to provide relief to estates containing farmland where the heirs continue to farm the land. The intention of the provision was to allow family farms and closely-held businesses to be retained by the family rather than be sold to pay estate taxes.

Section 2032A allows the estate to value the farmland for estate tax purposes at its value for farming purposes rather than at its theoretical highest and best use. To ensure that the farmland continues to be used for farming purposes, section 2032A also provides a recapture tax that is imposed if "qualified use" of the farmland ceases within ten years of the decedent's death. Disagreement over what constitutes cessation of qualified use is the issue with which this Subcommittee is concerned today.

It is acknowledged by all concerned that section 2032A is an exceeding complex statute. That complexity, together with generally restrictive interpretations of the scope of the statute by the Internal Revenue Service throughout the years, has led to numerous disputes over various provisions of the section. Indeed, the Congress has, on several occasions, intervened legislatively in these disputes in order to resolve them. In fact, the issue to which this proposal relates was itself the subject of previous Congressional intervention.

Cessation of qualified use of farmland is defined in section 2032A(c)(6) to be:

(1) cessation of use as a farm for farming purposes; or

(2) cessation of material participation by a qualified heir or any member of the heir's family (defined as an ancestor, spouse, lineal descendant or spouse of a lineal descendant of the qualified heir).

The IRS contends that a qualified heir that rents the farm to other family members on a net cash basis (rather than by means of a crop share lease) is not using the farm in a qualified use even though the other family members continue to farm it. Rather, according to the IRS, the farm is being used in a passive rental activity. This cash rental would, under the IRS view, cause the recapture tax to be imposed even though only family members are operating the farm.

The IRS position is not supported by the language of section 2032A. Indeed, the statute itself states that use of the farm for farming purposes constitutes qualified use. On the other hand, the other requirement -- material participation --

has always been acknowledged to require direct involvement by the qualified heirs or members of their family. All agree that this requirement would not be met where the farm was cash rented to a non-family members. On the other hand, where the farmland is rented by one qualified heir to another qualified heir or to a family member, the material participation test has been met.

The better interpretation of the statutory scheme is that section 2032A(c)(6) sets out two, non-overlapping requirements to avoid imposition of the recapture tax: (1) the farm must be used as a farm; and (2) the qualified heirs or their families must be directly involved in its operation. Stated another way, if the qualified heirs or their families cease to operate the farm or if they operate the farm as something other than a farm, the recapture tax will be imposed.

The IRS interpretation, in effect, imposes the material participation requirement twice even though the language of the statute only imposes the test once. The IRS position was not asserted until 1981. Until that time, no distinction was made between crop share leases and cash leases of the family farm.

The 1981 IRS position caught many families by surprise since it was not apparent from the language of the statute. Had they known, they could easily have met the requirements by using crop share leases. This is borne out by the fact that since the IRS position became public in 1981, virtually no one has been tripped up by the use of cash leases between qualified heirs and members of their families. It is only those who cash leased before the IRS position became known that were caught unaware and seriously harmed by the IRS position.

The IRS interpretation has been upheld by the courts, primarily on the basis of legislative history written in 1988, twelve years after special use valuation was enacted. However, whether or not the courts should or should not rely on legislative history written twelve years after the fact is not the central issue. The issue really is whether or not farm families who were caught wholly unaware by the IRS position should be made to suffer the penalty of the recapture tax when they have continued to use the farm for farming purposes through means of a cash rental. These are not people who have violated the spirit of the statute. The IRS seeks to impose the recapture tax on the basis of a foot fault.

PROPOSED AMENDMENT

The proposed amendment would clarify that qualified use does not cease merely because a qualified heir cash leases the family farm to another member of that person's family. The amendment is retroactive to 1976 when section 2032A was enacted. This retroactive change is necessary in order that qualified heirs who cash leased before the IRS issued its interpretation in 1981 are not disadvantaged unfairly.

Changing the law to allow qualified heirs to cash lease the family farm to other family members will help preserve family farms. It will allow those families to structure their financial affairs as they see fit without doing any violence to the purposes of special use valuation. Section 2032A was intended to preserve the family farm by valuing it as a farm rather than at its highest and best use. The proposed amendment would only benefit those families who have continued to use the land for farming purposes.

The distinction between a cash lease and a crop share lease is relatively minor and certainly not of a magnitude that should cause the loss of the protection of section 2032A. A cash lease is just what the name implies: the payment of cash by the lessor to the lessee for use of the property. A crop share lease, on the other hand, requires the lessee to share in the costs of producing the crops, as well as the profits therefrom, on a percentage basis. In substance, the distinction is one of protection from loss if the farm is not profitable: cash lease payments would be paid notwithstanding that the farm loses money.

However, this distinction is essentially beside the point in this debate. The real issue is whether the IRS position had any basis when it was announced in 1981 and whether, given that the announcement was not and likely could not have been anticipated by those using section 2032A, it is fair for the IRS position to apply to them.

This proposal is somewhat in the nature of a technical correction. Somehow the statute was interpreted incorrectly; this proposal would fix the statute. In fact, if the Congress were so inclined, it could even prohibit cash leases to family members prospectively so long as the problem for those families who acted before 1981 was fixed retroactively.

Special use valuation was intended to allow families to retain the family farm after the head of the family dies rather than selling the farm to pay estate taxes. It was not intended to be limited by technical distinctions between crop share and cash leases that have virtually no economic effect.

The proposed change was included in the Conference Report on H.R. 11 as section 4707. The estimated revenue loss at that time was $15 million over five years. Thus, Congress is on record as agreeing to overturn the IRS position as overly restrictive.

CONCLUSION

Use of cash leases rather than crop share leases should not result in cessation of qualified use under section 2032A. We urge the Ways and Means Committee to adopt the proposal.

Thank you, Mr. Chairman, and members of the Subcommittee.

DESIGNATED REPRESENTATIVES:
Ronald L. Platt
Gregory F. Jenner
McDermott, Will & Emery
1850 K Street, N.W.
Suite 500
Washington, DC 20006
Phone: 202-778-8029

STATEMENT BY THE AMERICAN PETROLEUM INSTITUTE FOR THE PRINTED RECORD OF THE JUNE 24, 1993 HEARINGS ON FOREIGN TAX PROVISIONS BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS AND MEANS OF THE U.S. HOUSE OF REPRESENTATIVES

Submitted June 24th, 1993

The American Petroleum Institute (API) represents approximately 300 companies involved worldwide in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

API welcomes several of the Proposals which are the subject of the Committee's Hearings. The Proposals would recognize transnational economic markets (Common Market and NAFTA) and reduce the risk of double taxation by relaxing adverse allocation and carryover limitations.

Because of the continuing depletion of U.S. petroleum reserves and diminishing domestic prospects, API members have to intensify their foreign presence. Thus, more equitable rules of U.S. taxation of foreign source income are of prime concern. Efforts must continue to make U.S. companies more competitive with respect to the typically more favorable home country taxation of their foreign competition. Such efforts will contribute to a continuing foreign presence of U.S. oil companies which assures not only employment of U.S. personnel both abroad and in domestic support functions, but also exports of equipment and supplies from the U.S. for use in the foreign operations.

Our comments follow the list sequence of the Hearing Notice.

II. To modify subpart F and to encourage expansion of U.S. business into the European Community.

H.R. 1401, introduced by Mr.Gibbons on March 13, 1993, would treat, with certain qualifications, all countries comprising the European Community (EC) as a single country for purposes of the subpart F rules on foreign base company sales income and foreign base company services income. To be included as a qualifying member nation, the particular EC country must have a maximum statutory tax rate greater than 90% of the maximum U.S. corporate rate and must not allow tax holidays or other preferential tax status for the CFC's income.

The Proposal is a welcome recognition of economic realities. Where the perceived taint of tax arbitrage through cross-border transactions is missing, section 954 of the Code excepts what would otherwise be subpart F income if derived from transactions within the CFC's country of incorporation. The Proposal applies the same rationale of excepting transactions within one national economy to the unified market of the EC nations. The Proposal is an update and adaptation to the economic realities of treaty created unified markets. In addition, the Proposal is an important step in the reduction of the disadvantage CFCs experience in the Common Market vis a vis their EC based competitors.

But the recognition of the EC as one country should also apply to the "same country" exception for foreign base company oil related income under subsection (g)(1)(A) and (B) of Code section 954. Without such modification the EC recognition as one country would depend on whether or not the subject of the transaction is oil or gas (or a primary product). For example, a

CFC's sale in Germany of gasoline from its refinery in The Netherlands would continue to be tainted, even though the transaction takes place within the borders of what now is recognized as one economy. Accordingly, the proposed amendment to Code section 954 should be made applicable also to subsection (g) on foreign base company oil related income.

III. Pre-87 Shipping Losses: allow carryforward against post-86 shipping income where substantially all of pre-87 shipping income was included in income.

Effective for a CFC's taxable years after 1993, the Proposal would allow the pre-1987 shipping losses of a CFC to be applied against post-1986 shipping income if substantially all of the pre-1987 shipping income was included (i) in the CFC's foreign base company income (without reduction under the former reinvestment rule) or (ii) in the U.S. shareholder's gross income, in a taxable year before 1987.

Without indicating a rationale, the 1986 Act prohibited the use of pre-effective date CFC losses to reduce a CFC's post-effective date subpart F income. P.L. 99-514, section 1221(f). The Technical Corrections and Miscellaneous Revenue Act of 1988 (TAMRA) *retroactively* reversed the prohibition of a carryforward of pre-1987 losses from base company sales, services, and oil related activities, but not for shipping. P.L. 100-647, section 1012(i).

No sound policy reason is apparent for disallowing the carryforward of pre-1987 shipping losses. Pre-1987 law allowed the use of shipping losses against any subpart F income. Post-1986 law allows the use of post-1986 shipping losses against subpart F shipping income. Ironically, the transition rules are harsher than the post-1986 regime. That this is not an appropriate transition rule has been recognized by the retroactive 1988 TAMRA change for base company sales, service, and oil-related losses. The Joint Committee Explanation to TAMRA defended the retention of the disallowance of shipping losses with the argument that shipping generally avoided capture as subpart F income before the 1986 Act. Description of the Technical Corrections Act of 1988 (H.R.4333 and S.2238), at 281, [JCS 10-88, 3/31/1988]. This is an erroneous assumption; some companies were taxed on pre-1986 Act shipping income under subpart F. Certainly, such companies deserve a proper transition rule which allows carryforward of pre-1987 shipping losses.

The Proposal would correct this inequity and asymmetry in the treatment of pre-1987 shipping losses. Since the Proposal would correct a flaw in the transition rule of the 1986 Act, it should be made retroactive so that pre-1987 shipping losses, as qualified under the Proposal, can be used against post-1986 shipping income, without limitation to post 1993 taxable years of the CFC. The above mentioned comparable transition rule corrections in TAMRA for base company sales, service, and oil-related income were also retroactive to the effective date of the 1986 Act.

IV. Consolidated return election for Contiguous Country Corporations to be allowed regardless of local law requirements.

This Proposal would eliminate the local law requirement of foreign incorporation for consolidation eligibility; however, from the Description of Miscellaneous Tax Proposals (JCS-08-93) [prepared by the Staff of the Joint Committee on Taxation, June 16, 1993] it would appear that the election includes all otherwise eligible CFCs in the respective contiguous country (Id., at 94).

The Proposal is a commendable implementation of the goals and spirit of the North American Free Trade Agreement. Moreover, since the interpretation of the local law requirement is plagued by administrative uncertainties, its removal would contribute to administrative efficiency and compliance simplification.

However, it is important that existing reporting structures are not adversely affected. Thus, the transition rules should make it clear that only elections made after the effective date require the inclusion of all eligible CFCs; the reporting status of companies for which an election had been made in the past must remain unaffected until a new election is made.

V. State tax allocation: to U.S. source only.

In general, Treas. Reg. § 1.861-8(e)(6), T.D. 8337 (March 1991), requires allocation of State income taxes or income based franchise taxes to foreign source income if taxable income determined under State law exceeds Federal taxable income as determined under the Code. Because of the often substantial variances of these two tax bases, U.S. taxpayers may be subject to double taxation because foreign taxes attributable to the foreign income that is eliminated by the misallocation of State taxes will not offset U.S. tax on worldwide income.

The Proposal would effectively abolish this misallocation which is flawed in principle and design. State income taxes are a cost of doing business in a particular State and often have nothing to do with a U.S. taxpayer's foreign operations; they should affect only income generated from activities within the State. From a technical standpoint, the allocation rule is defective because it compares State taxable income with taxable income under the Code; the respective regimes may differ substantially as to inclusiveness and timing.

VI. Eliminate the "substantially all" requirement in the active trade or business exception from FPHC income regarding commodities trading in Code section 954(c)(1)(C)(ii).

Under the Proposal, the net income from active business sales of commodities would not be taken into account in determining foreign personal holding company income by a CFC which is an active producer, processor, merchant, or handler of commodities, regardless of - as required under current law - whether such activity represents "substantially all" of its business. Treasury Regulations deem the current law's "substantially all" requirement met if 85 percent of the CFC's taxable income is derived from the qualifying activity.

The Proposal retains the critical aspect of the exception: the CFC must use the commodities in its active trade or business. But the elimination of the "substantially all" requirement, particularly as interpreted by Treasury Regulations, removes an unnecessary restriction on taxpayers' choice of efficient business structures. Under the Proposal, taxpayers no longer will have to forego the exception if they do not have the luxury of isolating qualifying commodities activities in a separate CFC. Similarly, they will no longer risk disqualification for the exception in a year with abnormal financial results where a normally minor "other activity" outperforms in taxable income substantial commodities processing and marketing operations. The Proposal removes these restrictions on corporate structures and eliminates the exposure to punitive current taxation before repatriation merely because of adverse operating results.

VII. FTC Carryforward: extend from 5 to 15 years.

The Proposal would be a long overdue step towards reducing double taxation because of timing differences between host country and U.S. tax regimes.

However, as proposed in section 113 of H.R. 5270, introduced last year, API believes that the carryback period should be extended from 2 to 3 years, for credits generated after the effective date.

It is axiomatic that creditable foreign taxes are paid on earnings and profits as computed according to foreign law, while the timing of their creditability under the Code is determined by earnings and profits computed according to U.S. principles. U.S. v. Goodyear Tire and Rubber Company et al., 89-2 USTC para. 9491 (S.Ct. 1989). This difference in foreign and U.S. tax bases *per se* mandates liberal carryover rules for foreign taxes that are creditable against U.S. taxes. Carryover periods should be at least as long as the timing differences between the foreign and U.S. tax regimes.

The changes to the foreign tax credit provisions in the 1986 Act made length of the carryback and carryover periods for unused credits even more critical. From a relatively simple bifurcated regime, which distinguished between income from active business operations and passive interest, the 1986 Act brought a complex, fractured system with 9 or more baskets which dramatically decreased the opportunities for using excess credits within the 7 years allowed by current law.

An extension of the utilization period to 18 years, by expanding the carryback to 3 years, in addition to an extension of the carryover period to 15 years, would reduce the double taxation exposure from tax credit expiration. This would update and adapt the carryover regime to the post-1986 restrictions on credit utilization, within the spirit and rationale underlying the introduction of the foreign tax credit carryover provisions in the Technical Amendments Act of 1958 (P.L. 85-866; H.R. Rep.No. 775, 85th Cong., 1st Sess. 27-8 [1957]). Obviously, the extension of the carryover period for net operating losses in the Economic Recovery Act of 1981 is also a weighty precedent.

STATEMENT OF BELL ATLANTIC CORP

EXECUTIVE SUMMARY

Bell Atlantic Corporation, based in Philadelphia, is the parent company of New Jersey Bell, Bell of Pennsylvania, Diamond State Telephone (Delaware), and the Chesapeake and Potomac Telephone Companies of Maryland, Virginia, West Virginia, and Washington, D.C., which provide a full array of telecommunications services in the mid-Atlantic region.

Bell Atlantic is also the parent of one of the nation's largest cellular carriers and of companies that provide software, systems integration, hardware and software services and support, and financial services throughout the United States and internationally. In addition, Bell Atlantic International offers network services and consulting to telephone authorities throughout the world and owns an interest in Telecom Corporation of New Zealand.

We appreciate the opportunity to submit comments for the record on interest allocation.*

It is our view that the interest allocation rules applicable in computing the foreign tax credit limitation should be modified for the telecommunications industry.

Interest allocation relief:

--is necessary to increase utilization of the foreign tax credit by U.S. telecommunications companies that pay a higher effective tax rate on their foreign earnings than on their U.S. income.

--would bring the U.S. tax rules applicable to the international investments of U.S. based telecommunications companies more in line with the tax rules of foreign countries, and thus increase the international competitiveness of the U.S. telecommunications industry.

--would not significantly increase the complexity or administrative burden of the foreign tax credit rules.

To benefit the U.S. based telecommunications industry, Bell Atlantic strongly urges properly drafted legislation to change the provisions of current law which require a portion of a U.S. multinational's interest expense to be allocated to its foreign source income in computing the limitation on its foreign tax credit. We propose that the interest allocation revisions included last year in H.R. 5270, the "Foreign Income Tax Rationalization and Simplification Act of 1992," be modified by substituting a 10% ownership threshold with relief limited to the U.S. taxpayer's pro rata share of the interest expense (and assets) of the foreign company.

DISCUSSION

In general, U.S. multinationals are subject to U.S. taxation on their worldwide income from both foreign and domestic sources. The mechanism that is intended to mitigate the potential for double taxation of foreign income is the foreign tax credit. However, the foreign tax credit available in a given year cannot exceed the lesser of the foreign tax paid or the "foreign tax credit limitation". The foreign tax credit limitation is computed as follows:

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*We note that Pacific Telesis Group, Southwestern Bell Corporation and GTE Corporation have authorized Bell Atlantic to state that they are in general agreement with these comments.

$$\frac{\text{Foreign Source Taxable Income}}{\text{World wide Taxable Income}} \times \text{Tentative U.S. Tax}$$

(where the "tentative U.S. tax is the U.S. tax on worldwide income before taking the foreign tax credit into account).

For purposes of computing "foreign source taxable income" certain expenses, notably interest expense of all members of the domestic affiliated group regardless of whether they have any foreign source income, are allocated in part to foreign source income. Specifically, the total interest expense of all members of the domestic affiliated group is allocated against foreign source income in the same ratio as either the fair market value or the tax basis (at the taxpayer's election) of the taxpayer's foreign assets bears to the fair market value or tax basis of its total assets.

The impact of the interest allocation rules depends on many factors, including the amount and type of the U.S. multinational's foreign source income and the amount of expenses allocated against it. As a result of these rules, the U.S. taxpayer is often precluded from claiming a foreign tax credit for some or even all of the foreign taxes paid on its foreign source income. This amounts to an incremental U.S. tax on foreign source income over and above the foreign tax on the same income. The combined foreign and U.S. effective tax rate in such situations can be much higher than the combined tax rate to which its foreign competitors are subject.

In addition to the amount and type of foreign income and allocable expense, the amount of interest expense of members of the domestic affiliated group has a direct bearing on the impact of the interest allocation rules. In general, for a taxpayer with excess foreign tax credits, interest expense incurred by members of its domestic affiliated group that is otherwise deductible and that is allocated to foreign source income reduces the foreign tax credit limitation (increasing the incremental U.S. tax) and thus, in effect, is rendered nondeductible. Therefore, another way to state the effect of the rules is that they potentially increase the cost of debt to U.S. multinationals with foreign operations.

In recognition of the need for modification of the interest allocation rules, H.R. 5270, the "Foreign Income Tax Rationalization and Simplification Act of 1992", was introduced by Chairman Rostenkowski in 1992, and extensive Committee hearings on the proposed bill were held.

H.R. 5270 contained a provision (section 101) intended to mitigate the harshness of the interest allocation rules under current law. Section 101 of H.R. 5270 essentially would allow taxpayers to offset the amount of interest expense that would otherwise be allocated against foreign source income by the amount of interest expense incurred by the foreign subsidiaries. This approach to mitigating the interest allocation problem has been called "worldwide fungibility" in the Treasury Department Study, "International Tax Reform: An Interim Report", dated January 15, 1993 ("Treasury Study"). As discussed in more detail below, the H.R. 5270 proposal is subject to a significant limitation in that it would apply only to foreign subsidiaries in which the U.S. multinational owns at least 80%.

While the H.R. 5270 interest allocation relief, as introduced, would provide relief to U.S. multinationals that conduct their foreign business through 80% or more owned subsidiaries, it offers no relief whatever to multinationals that conduct their international operations in less than 80% owned subsidiaries. In the telecommunications industry, a common form of foreign investment is a joint venture structured as a corporation in which the U.S. multinational owns less than 80% and often less than 50%.

This ownership limitation is often not a matter of choice for the U.S. telecommunications company, but rather is required by the foreign government in the privatization of its telephone system or in the competitive bid specifications for a cellular telephone license. Thus, the U.S. telecommunications company entering a foreign market is often limited to holding a minority interest in a foreign corporation. For example, Bell Atlantic and another U.S. company are limited to a permanent ownership of 49% in Telecom Corporation of New Zealand, and this ownership limitation was specified by the New Zealand government as one of the conditions of privatization of Telecom. Similarly, Bell Atlantic and another U.S. company jointly are permitted to own no more than 49% of the companies that hold cellular licenses in the Czech and Slovak Republics. Such ownership restrictions are common with respect to licenses and franchises granted by foreign governments to provide telephone, cellular, or cable TV services. Indeed, the U.S. places similar restrictions on foreign investment in licenses issued by the FCC.

In discussing the problems created by the interest allocation rules under current law, and the worldwide fungibility approach as a possible solution, page 38 of the Treasury Study states that "[the current interest allocation approach] effectively treats debt incurred by a U.S. parent corporation as if it supported investment in foreign subsidiaries to the same extent that it supports investment in domestic activities. This assumption ignores the economic reality that foreign subsidiaries borrow to support their own activities and thus can result in overapportionment of interest expense to foreign source income."

This potential for overapportionment of interest expense to foreign source income under the current interest allocation rules is not limited to foreign subsidiaries in which the U.S. multinational owns 80% or more owned subsidiaries. Although presumably an 80% ownership threshold was used because of current Code sections defining affiliations, the use of a lower threshold is equally legitimate. Bell Atlantic suggests that the threshold should be tied to the ownership requirements of section 902 for the deemed paid tax credit.

Foreign companies of which the U.S. multinational owns 25%, or 10%, are just as likely to borrow to support their own activities, but these investments still count as foreign assets that draw a share of the U.S. interest expense, and therefore can cause the same overapportionment of interest expense as the 80% or more owned subsidiary. For this reason, the solution to the interest allocation problem, at least for the telecommunications industry, cannot be limited to 80% or more owned subsidiaries.

Therefore, Bell Atlantic suggests that although the H.R. 5270 version of worldwide fungibility could be used as a starting point for a relief measure for the U.S. telecommunications industry, it should be modified in two ways. First, a 10% ownership threshold (or, more specifically, a threshold tied to the ownership requirements of eligibility for the deemed paid foreign tax credit in section 902) should be substituted for the 80% ownership threshold. Second (and consistent with the lower ownership threshold), relief should be limited to the U.S. taxpayer's pro rata share of the interest expense (and assets) of the foreign company. Examples are attached.

ATTACHMENT

Example 1: 100% Owned Subsidiary

Example 1 illustrates how H.R. 5270's version of worldwide fungibility would increase the foreign tax credit limitation and would potentially increase the foreign tax credit.

Assume that a U.S. multinational taxpayer ("P") is a company with operations in the United States and one wholly owned foreign subsidiary doing business abroad. Assume that P's tax basis in the stock of this foreign subsidiary is $150, and the tax basis of the subsidiary in its assets is $230. P's tax basis in its U.S. assets is $1000. Thus, the ratio of P's foreign assets to its total assets under current law is $150/$1150, or .13. (It is assumed that a fair market value method election is not made.)

Assume that P's net income from U.S. sources is $100, including $50 of interest expense. P's foreign subsidiary earns $14 of after-tax profits, including $8 of interest expense. It pays foreign tax of $9 on its $23 of pre-tax profits (an effective foreign tax rate of 39%), and distributes the $14 of after-tax profits to P as a dividend. There is no foreign withholding tax on the dividend, and the dividend is grossed up to $23 for U.S. tax purposes. The foreign subsidiary's business is all conducted in the country of its incorporation.

The tentative U.S. tax on P's $123 of worldwide taxable income would be $42 at a 34% tax rate.

a) Current Law

Under current law, the foreign tax credit limitation would be $5.63, computed as follows:

Interest expense allocable to foreign sources:
Interest expense of U.S. group member: $50
Interest times foreign asset ratio = $50 x .13 = $6.52.

FTC Limit: $\frac{\$23 - \$6.52}{\$123} \times \$42 = \$5.63$

Excess Foreign Tax Credits: $9.00 - $5.63 = $3.37

b) H.R. 5270 Worldwide Fungibility

Under H.R. 5270, P would first determine the total interest expense of its "expanded affiliated group", which would include, in addition to any domestic subsidiaries, its foreign subsidiary because that subsidiary is at least 80% owned. P would then determine the portion of this interest expense that is allocated to foreign source income using the ratio of foreign assets of the expanded affiliated group as follows: $230/$1230 = .187. However, P would then get an offset to the interest expense so determined for the interest expense of the foreign subsidiary.

Under H.R. 5270, P's FTC Limitation would increase to $6.88, computed as follows:

Interest expense allocable to foreign sources:
Interest of Expanded Affiliated Group: $58
Interest times foreign asset ratio: $58 x .187 = $10.85
Less offset for foreign interest paid: ($ 8.00)
net = $ 2.85

FTC Limit: $\frac{\$23 - \$2.85}{\$123} \times \$42 = \$6.88$

Excess Foreign Tax Credits would Decrease by $1.25 to $2.12 ($9.00 - $6.88)

Example 2: 25% Owned Subsidiary

Example 2 illustrates how a modified version of Section 101 of H.R. 5270 would increase the foreign tax credit limitation in situations where the U.S. telecommunications company owns less than 80% of the foreign company.

Assume that P owns only 25% of the foreign subsidiary considered in Example 1. Under current law, the tax basis of P's foreign asset would be $37.50 instead of $150, its total asset tax basis would be $1037.50, and its foreign asset ratio would be $37.50/$1037.50, or .04. The foreign entity's interest expense would be $8, of which P's pro rata share would be $2.00. P's pro rata share of the foreign tax paid by the foreign subsidiary is $2.25. The grossed up dividend would be $5.75.

P's U.S. source income and interest expense would remain unchanged, so its worldwide taxable income would be $105.75, which would attract a U.S. tentative tax of $35.96.

a) Current Law and H.R. 5270

The treatment of P under current law would be the same as the treatment under Section 101 of H.R. 5270 proposal, since, given the 25% ownership level, the interest allocation relief under H.R. 5270 would not apply to P.

Interest expense allocated to foreign sources:
Interest of U.S. member of group: $50
Interest times foreign asset ratio = $50 x .04 = $2.00

FTC Limit: $$\frac{\$5.57 - \$2.00}{\$105.75} \times \$35.96 = \$1.28$$

Excess Foreign Tax Credits = $2.25 - $1.28 = $.97

b) Worldwide Fungibility Proposal, Revised Per Above

The ratio of foreign assets of the expanded group would be as follows:

$$\frac{.25 \times \$230}{\$1000 + (.25 \times \$230)} = \frac{\$57.50}{\$1057.50} = .054$$

If a pro rata limitation is substituted for the 80% ownership threshold, the result, using the facts of the example above, would be:

Interest expense allocated to foreign sources:
Interest of Expanded Group: $52
Interest times foreign asset ratio: $52 x .054 = $2.80
Less offset for pro rata share of
foreign interest paid: ($2.00)
net = $ .80

FTC Limit: $$\frac{\$5.75 - \$.80}{\$105.75} \times \$35.96 = \$1.68$$

Excess Foreign Tax Credits would Decrease by $.40 to $.57 ($2.25 - $1.68)

Thus, in this example, under a worldwide fungibility approach, P would get a foreign tax credit of $1.68 to offset significantly more of the U.S. tax on the $5.75 of foreign source gross income.

STATEMENT OF DEAN R. O'HARE
CHUBB CORP

I. OVERVIEW.

A. Introduction

I am Dean R. O'Hare, Chairman and Chief Executive Officer of The Chubb Corporation. I want to take this opportunity to comment on the goals of H.R. 1401, which would amend the Internal Revenue Code to remove tax barriers inhibiting the competitiveness of United States-owned businesses operating in the European Community. H.R. 1401 would go a long way toward allowing U.S. manufacturers to rationalize and consolidate their European operations, by treating the European Economic Community (the "EEC") as one country for purposes of determining a controlled foreign corporation's foreign base company sales income and foreign base company services income under subpart F of the Internal Revenue Code.

I believe the goals of H.R. 1401 are worthy, but that it is essential to extend the changes proposed by H.R. 1401 to insurance income. As I will discuss below, the current tax rules impede the international competitiveness of the U.S. insurance industry.

After providing a brief background on our company, I would like to make three key points. First, the world insurance market is growing and could provide U.S. insurers expanded opportunities to the benefit of the U.S. economy. Second, a modest amendment to the Internal Revenue Code is necessary to remove a serious competitive disadvantage imposed on U.S. insurers doing business in foreign countries. Lastly, when legislating to enhance U.S. industry competitiveness, we ask that your Committee and the Congress be sure that insurance is included. U.S. insurers are among the best in the world. If U.S. insurers are given an equal chance, their expansion in the world market could be of great benefit to the U.S. economy.

B. The Chubb Insurance Group.

Chubb & Son, Inc. has been in the insurance business since 1882. From the beginning we have participated in the international market. The Chubb Corporation, organized in 1967, is a holding company primarily engaged through its subsidiaries in the business of writing property and casualty insurance on a worldwide basis. Chubb subsidiaries also are engaged in writing life and health insurance and in real estate development. By the end of 1992, Chubb's assets exceeded $15 billion, with revenues of almost $5 billion for the year.

We employ almost 10,000 people in 72 offices throughout the United States and abroad, including offices in Canada, Europe, South America, Australia, Hong Kong, Japan, Singapore, Korea, and Taiwan. We own or control facilities in most of the countries of the EEC and we maintain correspondent relationships, which when all taken together, provide Chubb with a presence in 92 countries worldwide.

Importantly, our aim is to increase our international activity to the point where it accounts for 25% of our total revenues by the year 2000. In short, we are committed to being a major insurer in the world markets.

II. THE WORLD INSURANCE MARKET.

Let me begin with several observations on the world insurance market. Following this discussion, I will comment on developments in the EEC.

A. World Market - Size and Potential.

When last measured, for the year 1990, the U.S. insurance industry's direct overseas investment totalled about $15.5 billion.[1] This was about 3.7% of total U.S. overseas investment.[2] However, the number of U.S. players in the international markets is small. There are only a handful today. This result occurs despite the size and potential of the world insurance market as evinced by the following key indicators:

- World premium volume in 1989 was over $1.2 trillion;[3]
- Real premium growth is measurably greater than that of the world GNP;[4]
- The U.S. share of world premium volume declined in the two years ending in 1988 from 43% to 37%. One-half of the decline was due to the soft dollar but the other half was real.

By not operating overseas, U.S. insurers, therefore, are denying themselves about 63% of the market, which is enjoying a growth rate far exceeding the U.S. market.[5]

B. Existing Barriers To Expanding Insurance Operations.

U.S. insurers have not availed themselves of certain foreign markets. An important part of the failure by U.S. insurers to expand globally is due to an array of protectionist devices denying U.S. and other foreign insurers equal opportunity. However, current U.S. tax policy, as further discussed below, also plays a role in impeding that expansion.

C. Developments in the EEC.

One of the important trends focusing attention on overseas markets is the underwriting and operational advantages from world regional groupings, in particular, the EEC. Although hurdles remain, the vision for the EEC is for competition throughout the EEC based on a single insurance license. In principal, underwriting expenses should be reduced because insurers will not be required to maintain full service offices in each country where risks are located. In addition, price competition should increase and product innovation likely will be encouraged. Merger and acquisition activity is already well underway. The intent of our international competitors is to create Pan-European operations and, in turn, integrate distribution systems offered by banking members of the same conglomerate.

There are still a variety of issues to be settled before EEC as one market is a reality for the insurance industry. But a major step was taken when the EEC agreed on standardized accounting regulations. This uniformity will significantly enhance the ability to write insurance throughout Western Europe.

D. Benefit to the U.S. Economy.

While the U.S. merchandise trade deficit shows some signs of abating, an increased services trade surplus may be the only answer to restore equilibrium to our Current Accounts balance of payments. In 1990, the services trade balance was almost $23 billion in surplus, double that in 1988 and it is growing.[6]

If we can enlarge the U.S. financial services presence in Europe, the prospects for substantially increasing the services trade surplus would be greatly enhanced.

We believe strongly that Congress should do all in its power to help assure equal opportunity for U.S. businesses in the global market. The U.S. can greatly improve its competitive stance in the EEC by amending the Internal Revenue Code to remove a serious competitive disadvantage affecting U.S. insurers.

III. THE INTERNAL REVENUE CODE PLACES U.S. INSURERS AT A COMPETITIVE DISADVANTAGE.

Under general U.S. income tax rules, a U.S. shareholder of a controlled foreign corporation (a "CFC") is not taxable on the earnings of such a corporation, until such earnings are distributed back to the United States as a dividend or upon liquidation. The purpose of Subpart F is to prevent deferral of U.S. tax through the unjustified use of tax havens. It accomplishes that purpose by subjecting to the Subpart F rules only certain limited categories of income. Under Subpart F, certain categories of undistributed income of U.S. CFCs are taxed currently to substantial U.S. shareholders, whether they be individuals or corporations.

Subpart F was not intended to prevent U.S.-owned enterprises from competing effectively with foreign-owned companies in foreign markets. However, U.S.-owned insurance companies are at a significant competitive disadvantage. For instance, U.S. insurers currently are required to organize separate subsidiaries in each of the twelve member states of the EEC in order to avoid having their underwriting income treated as Subpart F income. (As indicated earlier, Subpart F treatment results in current taxation in the United States even though the earnings have not been remitted.) Their foreign competitors operate under no such restrictions. By way of example, a Japanese-owned Belgium insurance company can underwrite risks in neighboring France, without subjecting its Japanese shareholders to current tax on its undistributed earnings. In contrast, a U.S.-owned Belgium insurance company would generate Subpart F income by underwriting French risks. To avoid Subpart F taxation of underwriting income, the U.S. shareholders would have to incorporate a separate French subsidiary, or establish a separate branch in France, and forego the cost savings and operating efficiencies available to the Japanese-owned Belgium company. In particular, such an approach would increase the amount of capital required to operate in each of these jurisdictions over what would be necessary if it was possible to operate through a single corporate entity throughout Europe.

Another disadvantage of the current Subpart F rules relates to the treatment of insurance company income. An insurance company, in the ordinary course of its business, invests its premiums in order to generate the necessary assets to pay off future claims. Most, if not all, foreign jurisdictions (as do many states in the U.S.), impose capital and legal reserve requirements and solvency requirements on insurance companies. Thus, in order to write insurance and accept reinsurance premiums, CFC's must maintain, and invest locally, a certain portion of their assets in connection with their insurance business. Subpart F currently taxes all such investment income, before it is remitted to the U.S., even though the CFC must retain such income.

Legislation was introduced in the 102nd Congress which addressed many of the problems discussed for U.S. insurance companies operating in the EEC. Specifically, H.R. 2320, the "Insurance Subpart F Reform and Improved Foreign Competitiveness Act of 1991," would have implemented three changes to Subpart F so as to limit the current competitive disadvantages. Unfortunately, H.R. 2320 was not enacted. The legislation the Committee today is considering, H.R. 1401, would remove the competitive impediments from some U.S. taxpayers in the EEC. However, H.R. 1401 covers only the foreign base company sales income and the foreign base company services income elements of what constitutes subpart F income under the Code. In its current form, H.R. 1401 would do nothing to enhance the competitiveness of U.S. owned foreign insurance companies, because the changes proposed by H.R. 1401 would not apply to the insurance income element of subpart F income.

Therefore, The Chubb Corporation recommends that H.R. 1401 be revised in such a manner that CFCs that are created or organized under the laws of any of the EEC countries would be able to treat risks throughout the EEC as "country of incorporation" risks, thereby avoiding Subpart F consequences on underwriting results in the EEC. This change would recognize that for insurance purposes the EEC will operate economically as one country. Consistent with H.R. 1401's existing anti-abuse rule, this change would not apply to any controlled foreign insurer incorporated in an EEC country unless the corporation is subject to a maximum statutory tax rate of greater than 90% of the maximum corporate U.S. tax rate.

The Chubb Corporation also recommends that the Committee make other changes to enhance the insurance industry's competitiveness. Investment income that constitutes an integral part of the insurance company's necessary reserves should be taxed only when such income is remitted to the U.S. Accordingly, specified investment income on reserves and surplus with respect to risks located in the country of incorporation should not be considered Subpart F income.

Finally, the "high tax exception" of the Subpart F rules should be changed to allow companies to use the tax accounting rules of their country of incorporation in qualifying for the exception. This change is necessary for insurance income, because most foreign countries tax insurance income on a narrower tax base than does the U.S., making qualification for the high tax exception by insurance companies a practical impossibility.

It is important to note that these changes we are recommending would not undercut the underlying purpose of the Tax Reform Act of 1986 changes to Subpart F: to prevent tax avoidance through routing income to tax havens. U.S. companies would not be fully relieved of the added tax burden that is not faced by their foreign competitors. However, we believe our recommended changes provide an excellent balance of the interests underlying the 1986 Act changes and the interest of not imposing too great a handicap on U.S. insurers competing overseas.

IV. CONCLUSION.

Global markets are opening. The Chubb Corporation plans to take advantage of these markets. If other service providers do the same, a balanced U.S. trade ratio could become a real possibility.

However, in order to permit us to take advantage of the opening markets, Supbart F should be amended to remove its serious competitive handicap for the U.S. insurance industry. Enactment of H.R. 1401, properly expanded as discussed above to address insurance issues, would accomplish this purpose while preserving legitimate tax policy concerns.

Finally, we recommend that whenever Congress legislates to enhance U.S. industry competitiveness, it should include insurance issues.

ENDNOTES

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3. Marbacher, J., ed. "World Insurance in 1989: Growth Rates - Growth Halved." sigma/Swiss Re. Zurich, 1991.

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6. Hawley, F. Wm. Remarks made on behalf of the Coalition of Service Industries before the subcommittee on International Economic Policy and Trade and the Subcommittee on Western Hemisphere Affairs. Committee of Foreign Affairs. U.S. House of Representatives (April 9, 1991).

Emergency Committee for American Trade 1211 Connecticut Ave Washington DC 20036 (202) 659-5147

July 6, 1993

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenue Measures
of the Ways and Means Committee
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The Emergency Committee for American Trade (ECAT) is pleased that your Subcommittee on Select Revenue Measures has held hearings on a number of foreign tax provisions.

H.R. 1401 is of interest to a number of our members. The bill would amend the Internal Revenue Code to treat the twelve European Communities members as a single country for purposes of determining foreign base company sales and service income when such income is subject to U.S. tax.

Such a change is necessary in that our European and Japanese competitors are in process of streamlining their operations to take advantage of the new unified market. However, unlike our foreign competitors, under existing subpart F rules U.S. multinationals must operate costly and duplicative subsidiaries in each European Communities country or be subject to a current tax on earnings before they are actually repatriated to the U.S. parent. The original purpose of Subpart F -- to deter U.S. companies from establishing subsidiaries in tax haven countries to avoid U.S. taxation -- is preserved in H.R. 1401, while obstacles are removed.

We believe that H.R. 1401 is not only both logical and reasonable, but that it also offers Congress an opportunity to take a first and painless step in improving the ability of U.S.-based multinational companies to compete more equally with our foreign counterparts in the countries of the European Communities. Accordingly, we urge you and your Subcommittee to favorably report on H.R. 1401.

Sincerely,

Robert L. McNeill

Robert L. McNeill
Executive Vice Chairman

STATEMENT OF THE NATIONAL FOREIGN TRADE COUNCIL, INC.
PRESENTED TO THE
HOUSE WAYS AND MEANS SUBCOMMITTEE
ON SELECT REVENUE MEASURES
JUNE 24, 1993

Mr. Chairman, and Members of the Subcommittee:

The National Foreign Trade Council, Inc. (NFTC) is pleased to present its comments on several of the miscellaneous tax proposals that were the subject of hearings held by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee.

The NFTC is a trade association with some 500 members, founded in 1914. Its membership consists primarily of U.S. corporations engaged in all aspects of international business, trade, and investment. The NFTC's emphasis is to encourage policies that will expand U.S. exports and enhance the competitiveness of U.S. companies by eliminating major tax inequities in the treatment of U.S. companies conducting business abroad.

Due to the international focus of the NFTC, we will confine our comments to several of the proposals that would modify existing tax rules that apply to international transactions.

In general, the NFTC would urge the Subcommittee to evaluate various proposals discussed in our statement based on certain objective criteria.

First, the proposal should promote tax compliance, decrease complexity, and reduce the administrative burdens to both taxpayers and the Treasury Department. It is widely accepted among tax practitioners that the rules governing the tax treatment of foreign income earned by U.S. taxpayers (as well as the tax treatment of foreign companies doing business in the U.S.) are inordinately complex requiring the expenditure of precious resources by taxpayers and the Treasury Department to achieve even modest compliance. Enactment of the measures discussed below, together with passage of numerous foreign simplification provisions introduced by Chairman Rostenkowski last year, would represent positive steps toward simplification in the international area.

Second, the proposal should enhance the ability of U.S companies to compete in foreign markets. Many economists and international tax experts have expressed the view that recent changes in the tax treatment of U.S. companies operating abroad have only served to compound the problems for U.S. companies seeking to penetrate or expand market share. This problem is heightened when U.S. companies are in direct competition with foreign-owned companies that do not operate under restrictive tax rules in their own countries.

Specifically, the NFTC wishes to submit comments on the following eight proposals that are listed as "Foreign Tax Provisions" in the pamphlet prepared by the staff of the Joint Committee on Taxation for these hearings.

1. Extension of Period to Which Excess Foreign Taxes May Be Carried. The NFTC strongly supports the proposal to extend the carryforward period for excess foreign tax credits from the present five years to fifteen years. The reasons for our strong endorsement of this measure stem primarily from our desire to avoid double taxation on economic income derived from multijurisdictional transactions. If excess foreign tax credits cannot be used due to the expiration of the carryover period, then double taxation of economic income has occurred.

Extension of the carryover period from five to fifteen years would have a highly beneficial impact on numerous U.S. companies, which have suffered from the global recession of the past few years. In this respect, the extension of the carryover period would mitigate the adverse effects of the interaction between net operating losses and excess foreign tax credits.

Recent changes to the foreign tax credit rules, including the creation of numerous separate limitation baskets and the interest allocation rules, have also caused many U.S. companies operating abroad to have excess foreign tax credits. An extension of the carryover period would mitigate the harsh effects of these changes.

The NFTC must also take exception to the reasons cited by the Administration for not supporting this proposal. In its statement before the Subcommittee, the Administration indicated that the foreign tax credit carryover rules were not designed to permit averaging of income and loss over several years, but instead were intended to mitigate timing differences between the U.S. and foreign laws. The Administration further contended that the Section 904 "foreign tax credit limitation baskets" were designed to foreclose averaging of high and low-taxed income.

The NFTC believes that the Administration's reasoning for not supporting an extension of the carryover period is inconsistent with the history of the foreign tax credit. Contrary to the Administration's statement that the Section 904 baskets were designed to foreclose averaging of high and low taxed income, the explicit intent behind the overall limitation basket in Section 904(d)(1)(I) is to permit full cross-crediting of foreign income taxes for business profits from manufacturing, marketing, and services (to the extent of the maximum U.S. corporate rate). The separate limitation baskets for the foreign tax credit contained in Section 904 were designed to foreclose averaging of high and low taxed income for passive income. (Emphasis supplied) In addition, the extension of the carryover period from five to fifteen years would further the goals of the overall limitation basket by reducing the incidence of double taxation on genuine business profits earned abroad.

The NFTC also notes with approval the inclusion of the fifteen year carryover provision in H.R.5270, which also proposed to extend the carryback period from two to three years. The NFTC voiced its strong support for that provision at the Ways and Means Committee hearings last year on H.R.5270.

2. Allocation to U.S. Source Income of Deductions for Taxes Paid to State and Local Governments. The NFTC supports the proposal to allocate all deductions for state or local income or franchise taxes to U.S. source income. Treasury regulations issued under Code Section 861 treat state income taxes as taxes directly applicable to the gross income with respect to which the taxes are imposed. This presumption belies the fact that state and federal foreign source income are determined under different tax rules with results that often differ with respect to timing and the scope of the tax base. Moreover, these rules demand an extensive analysis of the tax base for each state to determine the income that would be foreign source income for Federal tax purposes.

However, the most compelling objection to the current allocation rules for state and local income and franchise taxes to foreign source income is that the rules lead to double taxation in many cases. The regulations require an allocation of state taxes to foreign source income if the taxpayer's total taxable income for state tax purposes exceeds the U.S. source income for Federal income tax purposes. If this rule applies, any state tax allocation to foreign source income will cause double taxation by reducing the amount of the foreign tax credit. Moreover, the allocation rules can also cause double taxation on foreign income taxed by a state as a result of the fact that few foreign jurisdictions permit a deduction for state taxes paid in determining their own tax liability.

Finally, the current rules ignore the simple fact that state income taxes are a cost of doing business in a particular state, and allocation of state taxes to foreign business activities is unwarranted.

3. Revision of Certain Subpart F Income of Controlled Foreign Corporations (CFCs) in the European Community. The NFTC supports the proposal to modify the existing Subpart F rules with respect to the activities of Controlled Foreign Corporations (CFCs) doing business in the European community (EC). Current Subpart F rules, including the foreign base company sales and services income, require the current inclusion in income of 10 percent U.S. shareholders the income attributable to related party purchases if the income recipient's country is neither the origin nor the destination of the goods. Similar rules apply to service income. The proposal would allow countries in the EC to be treated as a single country for purposes of applying the foreign base company sales and services income rules under Subpart F. We would also urge that the proposal be expanded for all Subpart F purposes to enable companies to qualify, for example, for the same country exception for dividends and interest.

As the EC is beginning the process of harmonizing its tax and trade rules to promote cross-border investments within the EC by companies based in that region, the proposal to treat the EC as a single country for purposes of certain active Subpart F income would facilitate and promote the expansion of U.S. business in Europe.

Moreover, we believe that the Administration's reason for opposing this proposal is misplaced. The Administration indicated in its statement that the lack of direct tax harmonization in the EC creates inappropriate tax planning opportunities. On the contrary, the proposal was designed to prevent abuses by expressly providing that the proposal is inapplicable unless two conditions are met: first, that the country must have a maximum statutory tax rate greater than 90 percent of the maximum U.S. corporate income tax rate; and second, the country must not apply preferential taxation to foreign base company sales and services income of the CFC. The NFTC does not believe that the absence of a tax treaty with each EC country should preclude passage of an important proposal that would promote U.S. business operations in that region, provided that adequate safeguards to protect against abuses are established. In our view, the two conditions mentioned adequately protect the U.S. fisc against tax avoidance.

4. Carryforward of certain Pre/1987 Foreign-Based Company Shipping Losses. The NFTC supports the proposal to allow the pre-1987 shipping losses of a CFC to be carried forward and applied against its post/1986 shipping income if substantially all of the CFC's pre-1987 shipping income were included in its current gross income.

The Tax Reform Act of 1986 denied the use of pre-1987 CFC losses to reduce the post/1986 Subpart F income of a CFC. The Technical Corrections and Miscellaneous Revenue Act of 1988 reversed this prohibition of the carryforward of pre-1987 losses for foreign base company sales, services, and other related activities but not for pre-1987 shipping losses.

The NFTC believes that there is no sound tax policy justification to distinguish among the various classes of Subpart F income. Companies that paid tax on their pre-1987 shipping income deserve the proper transition rule to carry forward shipping losses that were incurred prior to 1987. At a 1990 House Ways and Means Committee hearing on the proposal to carry forward pre-1987 shipping losses, the Treasury Department testified that it did not oppose the amendment provided that it was drafted properly. The proposal would correct an inequity and place pre-1987 shipping losses on the same footing with other categories of foreign base company income.

5. Expand Foreign Sales Corporation Exemption for Military Property. The NFTC supports the proposal to repeal the limitation on Foreign Sales Corporation (FSC) tax benefits for export sales of military property. Present law limits the tax benefits for an FSC attributable to the export sales of military property to 50 percent of the amount which would otherwise be available for other export sales.

The NFTC contends that the reasons underlying the limitation, which was adopted over 15 years ago, no longer apply. The limitation was based on the premise that military products would not be sold in a competitive marketplace. Military export sales today are subject to fierce international competition. Moreover, a limitation on FSC benefits for military exports is unnecessary to curb the sale of arms abroad since military sales are currently subject to the requirements of the Arms Export Control Act.

In short, the NFTC supports the proposal to lift the 50 percent limitation as a means of enabling U.S. companies to more effectively compete against foreign competition in the export sales of military property.

6. Election to Treat Controlled Contiguous Country Corporations as Domestic Corporations. The NFTC supports the proposal to modify the consolidation rules of Section 1504(d) to make the election available to all Canadian and Mexican corporations included in the affiliated group irrespective of whether they are prohibited by local law from operating as U.S. corporations. The election would be binding on all Canadian and Mexican members of the affiliated group and could be revoked without the consent of the IRS. In essence, the proposal would remove the exception under present law that precludes contiguous corporations (i.e. Canada or Mexico) from joining in the filing of a consolidated return unless corporations are formed in those countries solely for the purpose of complying the with the title and property laws in those jurisdictions.

Removal of the incorporation restriction would promote harmonization of investment within the region in a manner consistent with the objectives outlined in the NAFTA agreement pending before Congress. The proposal would also represent a positive step to enhance consistency between U.S. tax and trade laws regarding international investment and business activity.

Finally, the NFTC rejects the Treasury's rationale for opposing this proposal. In its statement, the Treasury argues that the proposal would provide an election to claim losses incurred by contiguous subsidiaries. While this statement is true, the proposal is structured to require all Canadian and Mexican corporations that would be members of the affiliated group to participate in filing the consolidated return, and would not allow selective participation. We believe that this additional requirement would prevent any erosion of the tax base to the U.S. Treasury and would safeguard against potential abuses.

7. Commodities Income of A Controlled Foreign Corporation (CFC). The NFTC supports this proposal to delete the requirement that substantially all of the CFC's business must be in the capacity of an active producer, processor, merchant, or handler of commodities in order to avail themselves of the exception from the foreign personal holding company income rules under Subpart F for active business gains or losses from the sale of commodities.

The NFTC believes that the definition contained in the Treasury regulations of what constitutes "substantially all" is an overly stringent requirement that virtually precludes most commodity sales from qualifying for the exception. Under the Treasury regulations, "substantially all" is defined to mean that at least 85 percent of the CFC's total taxable income must be derived from active commodities business operations. It is the our view that elimination of the "substantially all" requirement would remove an unnecessary limitation on the use of the exception, while still maintaining the requirement that the exception is only available for commodity sales conducted in an active trade or business. The proposed revision would also be consistent with the basic thrust of the Subpart F rules of the Code, which generally are not designed to tax active business income of CFC's.

8. Increase in Reporting of Threshold for Stock Ownership of A Foreign Corporation. The NFTC strongly supports the proposal to raise the reporting threshold in Section 6046 to ten percent instead of five percent of the value of the ownership of stock in a foreign corporation.

The NFTC believes that this proposal would represent a modest step toward improving the administration of the tax laws for U.S. multinational companies with no revenue lost to the Treasury. Moreover, the 10 percent stock ownership threshold is consistent with other requirements in this area /i.e./ ability to claim the indirect foreign tax credit under Section 902, etc.

In addition to the proposals discussed above, the NFTC urges the Congress to adopt several important measures contained in the foreign simplification package introduced last year by Chairman Rostenkowski and subsequently approved by the Congress (although the legislation of which it was a part was not enacted).

These measures include: Extending the application of the indirect foreign tax credit under Section 902 and 960 to sixth-tier CFC's; simplification of the translation of foreign taxes into U.S. dollars; harmonization of the rules that exist under present law between the PFIC and Subpart F rules. The NFTC strongly urges adoption of these proposals to enhance compliance and greatly simplify the administration of the tax laws relating to international transactions.

The NFTC appreciates the opportunity to submit its comments on the various miscellaneous tax measures that are the subject of the Subcommittee's hearings.

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June 23, 1993

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue
Measures
Committee on Ways and Means
U.S. House of Representatives
1105 Longworth House Office Building
Washington, D.C. 20515

Re: *Miscellaneous Revenue Issues To Be Considered at June 24, 1993, Hearing*

Dear Chairman Rangel:

On behalf of Tax Executives Institute, I am pleased to provide the following comments on several foreign tax issues on which the Subcommittee on Select Revenue Measures will hold a hearing on June 24, 1993.

Background

Tax Executives Institute is the principal organization of corporate tax professionals in North America. Our approximately 4,900 members represent more than 2,400 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike. TEI is firmly committed to maintaining a tax system that works — one that is consistent with sound tax policy, one that taxpayers can comply with, and one in which the IRS can effectively perform its audit function.

H.R. 1401: Modification of Subpart F Rules

Under section 954 of the Internal Revenue Code, a U.S. parent company is currently taxed on sales or services income earned outside a controlled foreign corporation's (CFC's) home country. Income earned within the CFC's home country, however, is generally exempt from current taxation under Subpart F of the Code (the "same country" exception).

Introduced on March 18, 1993, by Representative Sam Gibbons, H.R. 1401 would treat the unified European Community (EC) as a single economic unit for purposes of the same country exception. Under the bill, a U.S. parent company would not be subject to current taxation with respect to the earnings of a controlled EC-country subsidiary derived from sales to customers located within another EC country.

TEI endorses the proposal to treat the EC countries as a single country for purposes of the same-country exception. The consolidation of the 12 countries comprising the EC into one economic unit last year presented U.S. companies with a competitive challenge. The initiative allowed EC-based companies to consolidate their European business opportunities, leading to a reduction of operating costs. Because of the rigidity of the same country exception, however, U.S. companies have been forced to choose between cost-efficient consolidation of operations in Europe or the loss of their deferral of taxation on income earned in the EC.[1] Treating the EC countries as a single unit would permit U.S. multinationals to consolidate their European subsidiaries into one efficient operation in a cost-competitive manner.

Sourcing of State Income Taxes

Section 861 of the Code generally requires taxpayers to allocate and apportion their taxable income and deductions among sources inside and outside the United States. Treas. Reg. § 1.861-8(e)(6)(i) provides that the deduction for state income and franchise taxes is definitely related, and thus allocable, to the gross income with respect to which those taxes are imposed. The Treasury Department's position is that activities in a state may generate both domestic- and foreign-source income, and thus the deduction for state income and franchise taxes must be allocated among that income. *See* Preamble to T.D. 8337, 1991-1 C.B. 92, 93. This position, however, is very controversial on both constitutional and administrative grounds.

The Subcommittee is considering a proposal to permit corporations to allocate to U.S.-source income all deductions for tax payments made to the states.

TEI endorses this proposal. The workload burden created by the Treasury regulations is tremendous, requiring the collection and analysis of additional data that are not maintained for any other purpose. Moreover, the regulations are based on controversial theoretical assumptions. The basic premise of the regulations — that states may and do tax foreign source income — is wrong; the state income tax is imposed on domestic business activities and represents a cost of doing business within the state. The proposal before the Subcommittee is the proper tax and economic result and should be adopted.

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[1] This situation is exacerbated by the proposed legislation to restrict the same country exception.

Foreign Tax Credit Carryover

Section 904(c) of the Code currently provides that any foreign tax credits (FTCs) not used against U.S. tax in the current year may be carried back two years and forward five. The rules for net operating losses under section 172(b), in contrast, provide for a three-year carryback and a fifteen-year carryforward.

The Subcommittee is considering a proposal to extend the period to which excess FTCs may be carried forward from five to fifteen years.

TEI endorses the proposal. In addition, we further recommend that the carryback period for such credits be extended from two to three years. The effect of the shorter time periods has been to cause FTCs to expire unused, thereby frustrating the purpose of the credit — the prevention of double taxation. There is no readily apparent policy reason for the harsher rules in the FTC area. For example, when originally enacted as part of the 1954 Code, the carryback/carryforward provisions in respect of net operating losses and the FTC were identical — two years back and five years forward. Although the rules have been liberalized several times for net operating losses since 1954, the FTC provisions have been ignored. The proposal would remedy this oversight and should be adopted.

Conclusion

Tax Executives Institute appreciates this opportunity to present our views on these international proposals. If you have any questions, please do not hesitate to call me at (408) 765-1202 or Timothy J. McCormally of the Institute's professional staff at (202) 638-5601.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

By: ______________________
Robert H. Perlman
International President

Statement of Luanne James
President
THE INFORMATION TECHNOLOGY ASSOCIATION OF AMERICA
(ITAA)

TREATMENT OF SOFTWARE LICENSING INCOME EARNED BY A FOREIGN SALES CORPORATION

June 24, 1993

ITAA is the trade association for this nation's computer software and services industry, whose more than 55,000 companies provide government and corporate America with business application and systems software for mainframe, midrange, and personal computers; custom and contract software programming services; information systems integration services; and information processing services. In 1990, the last year for which figures are available, U.S. information technology services companies generated over $400 billion in revenue, an increase of 6% over the prior year, and employed over 2.4 million people nationwide. The United States leads the world in information technology and the U.S. information technology industry contributes positively to the nation's economy and balance of trade.

As a member of the Foreign Sales Corporation (FSC) Software Coalition, which includes Oracle Corporation, Computer Associates, the American Electronics Association, AutoDesk, Borland, Cadence, Comshare, Lotus, Novell, Sybase and Wordperfect, ITAA endorses and supports the statement submitted June 24, 1993, on behalf of the FSC Software Coalition by General James A. Abrahamson, Chairman of the Board, Oracle Corporation, to the Ways and Means Subcommittee on Select Revenue Measures. The General's statement made it clear that exports of software through a foreign sales corporation, even when accompanied by the right to duplicate that software, should qualify for FSC benefits and that the legislative proposal being supported would accomplish this goal.

In an effort to encourage exports, Congress enacted the FSC rules and, indeed, the Clinton Administration's Commerce Department has been active in encouraging small and medium-sized software companies to export. However, due to an excessively narrow interpretation of the FSC rules by the IRS (see Temp. Reg. Sec. 1.927(a)-1T(f)(3)), the export of software accompanied by the right to reproduce is prevented from receiving this export incentive. This narrow definition of export property has no basis in statute or legislative history and ignores the similarities between the film, record and software industries, the first two of which receive FSC benefits even when their products are exported with rights to reproduce.

The IRS temporary regulation also fails to acknowledge three predominant methods by which U.S. software companies market their products overseas: 1. the licensing of a master tape or disk of the computer software to a foreign distributer, original equipment manufacturers (OEM's) and value-added resellers (VAR's); 2. the "site licensing" of software to large foreign customers; and 3. the licensing of a master tape to a foreign subsidiary that will, in turn, enter into a sub-license with the foreign customer. In each of these instances, the right to reproduce the software is, and must be, provided to the foreign licensee. The narrow interpretation of the FSC rules by the IRS as it relates to software exports thus effectively serves to deny any significant FSC benefit to the U.S. software industry for the very exports the Administration otherwise encourages. This is both economically counterproductive and inconsistent with the U.S. interest in encouraging the continued growth and leadership of this nation's software industry.

For these reasons, ITAA supports the enactment of legislation that would clarify that the definition of FSC export property includes the license of computer software to foreign customers and distributors with the right to reproduce.

STATEMENT OF CHEVRON CORPORATION ON CARRYFORWARD OF PRE-1987 FOREIGN BASE COMPANY SHIPPING LOSSES

HEARINGS ON MISCELLANEOUS REVENUE ISSUES BEFORE THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES

JUNE 24, 1993

Chevron Corporation believes that the Internal Revenue Code should be corrected to allow the pre-1987 shipping losses of U.S. controlled foreign corporations to be carried forward and applied against post-1986 Subpart F shipping income, particularly where the U.S. parent included pre-1987 shipping income in its income. The Tax Reform Act of 1986 prohibits the carryforward on any basis of shipping losses accumulated by U.S. controlled foreign corporations before 1987. The Technical Corrections Act of 1988 amended the Code to allow pre-1987 losses to reduce post-1986 Subpart F income in three other areas (base company sales, services and oil-related income).

The Subcommittee on Select Revenue Measures held a hearing on this carryforward proposal on February 21, 1990. There was no opposition to the proposal, and it was supported by the Federation of American Controlled Shipping and others. At that hearing, the Treasury Department testified that they did not oppose the proposal provided it was drafted properly. They further indicated that they had supported provisions of the 1988 technical corrections legislation that allowed pre-1987 deficits to reduce post-1986 Subpart F income in the same Subpart F category and that the carryforward of pre-1987 shipping losses amendment would place U.S. shareholders of CFCs that earn shipping income in a position equivalent to U.S. shareholders of CFCs that earn other types of Subpart F income. (Statement of Kenneth W. Gideon, Assistant Secretary of the Department of Treasury before the Subcommittee on Select Revenue Measures, February 21, 1990).

Since the hearings, there have been numerous discussions with the Treasury Department and Joint Tax Committee staffs and other interested parties to ensure that the carryforward amendment is properly drafted and has a minimal revenue impact.

No sound tax policy exists for eliminating the right to carry forward pre-1987 shipping losses. Before the 1986 Act, such losses could be carried forward. Under the 1986 Act, post-1986 shipping losses can be carried forward to reduce shipping income. The 1986 Act's complete prohibition of the carryforward of shipping losses accumulated as of the end of 1986 is thus harsher than either the old law or current law. Such a "transition" rule not only is an anomaly but also creates an inequity.

A complete lack of transition relief is an unreasonable penalty to impose, particularly on companies that currently reported income from shipping operations on their U.S. tax returns. These companies were relying on well understood rules of foreign shipping taxation. It would appear reasonable that if Congress changes the law as it did in 1986, it should allow taxpayers to utilize loss carryforwards properly accumulated prior to the change in the law.

The rationale that has been offered for the prohibition of shipping loss carryforwards is that shipping was one of the categories of Subpart F income that generally was not at risk of taxation prior to the 1986 Act. (See Joint

Committee on Taxation, Explanation of the Technical and Miscellaneous Revenue Act of 1988, p. 280-81). This rationale is faulty, however, because some U.S. companies included in their income the pre-1986 Act shipping income of their controlled foreign corporations.

The Technical and Miscellaneous Revenue Act of 1988 corrected similar inequities with respect to foreign base company sales, service, and oil-related losses by allowing the carryforward of pre-1987 losses in those categories. Losses from shipping operations deserve similar treatment.

Internal Revenue Code Section 952(c)(1)(B)(ii)(II) should be amended to allow a carryforward of pre-1987 accumulated foreign shipping losses, at least for taxpayers who took this Subpart F shipping income into account for income tax purposes during this period.

Thank you for your consideration on this issue.

STATEMENT OF PHILIP J. LOREE, CHAIRMAN
FEDERATION OF AMERICAN CONTROLLED SHIPPING ("FACS")
BEFORE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE WAYS AND MEANS COMMITTEE
JUNE 24, 1993

My name is Philip J. Loree. I am Chairman of the Federation of American Controlled Shipping, or "FACS." I thank the Subcommittee for providing this opportunity to comment on the issues being considered here today which involve the U.S. tax treatment of American controlled shipping.

FACS members are American companies controlling merchant vessels registered under the so-called open registries of Liberia, Panama, Bahamas and The Marshall Islands. For many decades American controlled vessels have represented the only means by which Americans could compete, without direct or indirect subsidies, against foreign owned vessels in the international marketplace, and at the same time be under Effective U.S. Control (EUSC) for requisition, use or charter by the United States in times of national emergency.

Over the past eighteen years substantial changes have been made in the way that the United States taxes international shipping. Several of these changes have directly and adversely affected the international competitiveness of American companies owning EUSC ships through controlled foreign corporations ("CFCs"), thus giving foreign owned companies a substantial competitive advantage. The result has been that in recent years the carrying capacity of the American controlled EUSC fleet has been declining at an alarming rate compared to foreign controlled shipping.

In 1975 Congress taxed unrepatriated CFC shipping income, except to the extent of reinvestment in certain shipping assets. No other country in which internationally competitive foreign shipowners are domiciled restricts deferral in this way.

The 1986 Act, in comparison to the 1975 Act, was immensely more onerous for American controlled shipping by reason of the fact that it imposed two crippling tax burdens on shipping CFCs. First, it eliminated any possibility of deferring tax on unrepatriated shipping income earned after 1986, thereby placing American controlled shipping at a capital cost disadvantage in attempting to compete against foreign shipowners in the world marketplace. Second, it unfairly denied American companies the right to carry forward pre-1987 shipping losses against post-1986 shipping income of CFCs.

Given the pressures from foreign competition and the role of American controlled shipping both in meeting U.S. emergency sealift needs and in supporting the maritime infrastructure of the United States, we believe that it is critically important to reexamine U.S. tax policy as it relates to such vessels. Consequently, we applaud the decision of your Subcommittee to undertake such a reexamination in this hearing.

Our testimony will focus first on the proposals to restore reinvestment deferral under Subpart F, and then on the proposal to permit carryforward of pre-1987 losses.

I. REINVESTMENT DEFERRAL UNDER SUBPART F

A. Impact on American Companies

From 1986 to 1992 the American controlled EUSC fleet declined by

101 modern merchant vessels of over 12,000,000 deadweight tons. Some appreciation of the severity of this decline can be gained by considering that to replace the lost tonnage today with newly built vessels at competitive world shipbuilding prices would probably require aggregate capital investments in the range of five billion dollars. Considered from another standpoint, the lost EUSC tonnage represents about 72% of the carrying capacity of the existing privately owned and operating U.S. flag merchant fleet.

Over the period from 1986 to 1992 the EUSC fleet was reduced by roughly one-third in terms of vessels and carrying capacity. Any suggestion that the decline was attributable to a shrinking demand for tonnage in the world marketplace must be judged in the light of the fact that carrying capacity of the remainder of the world fleet actually increased slightly over the same period.

These statistics have to be considered against the backdrop of the investment disincentive that was created by elimination of reinvestment deferral. As documented by the 1990 study on shipping tax laws which Price Waterhouse undertook for our organization, the 1986 Tax Act subjected American controlled open registry shipping to current tax, while all of the key foreign shipowning competitors have remained able to plow either untaxed or tax deferred earnings and profits back into the business which by its very nature is capital intensive.

As a result, a foreign controlled shipping company could invest each dollar it earned back into its shipping enterprise if its business judgment so dictated. But in order to match the reinvestment of its foreign competitor, an American controlled company would have to earn $1.52 in order to reinvest $1.00. (The pending tax bill would increase this burden because of the contemplated higher tax rate.)

Consequently the 1986 Act made acquisition of newly purchased vessels (whether newbuildings or used vessels) much more difficult and problematic for American companies. Another 1990 Price Waterhouse study undertaken for our organization determined that the loss of reinvestment deferral impacted much more severely on the acquisition of vessels than on the disposition of vessels.

The impact of the 1986 Act on vessels that would have been acquired by American companies except for the loss of reinvestment deferral cannot be precisely determined. Nevertheless, some appreciation of the lost acquisition opportunities can be drawn from the survey of American companies with EUSC tonnage which Price Waterhouse undertook in its 1990 study. Price Waterhouse estimated that acquisitions from mid-1989 through 1994 would have increased by about 1,000,000 deadweight tons per annum if both reinvestment deferral and carryforward of pre-1987 losses had been restored throughout that period.

With respect to the disposition of EUSC vessels, the Price Waterhouse survey estimated that over the period from mid-1989 through 1994 the existing EUSC fleet would be disposed of at a rate of about 925,000 deadweight tons per year. It further estimated that restoration of reinvestment deferral and carryforward of pre-1987 losses would slow the disposition rate by about 152,000 deadweight tons per annum.

The crippling impact of the 1986 Act on American controlled shipping can be attributed primarily to the fact that shipping is a capital intensive business requiring enormous investments to replace, modernize and expand fleet capacity, and to amortize loans on existing vessels. As a consequence, the cost of capital necessarily is a critical factor for shipowners. There is a constant pressure to replace or upgrade older vessels because of approaching obsolescence, fuel and design inefficiencies, technological developments, new safety and pollution prevention requirements, new cargoes and trading patterns and various other factors. In the years since 1986 these capital cost pressures have been exacerbated by sharp rises in the costs of new ship construction as the worldwide demand for available shipbuilding capacity has intensified.

The unfortunate fact is that as the capital pressures in shipping were about to accelerate, the 1986 Act effectively reduced the internal funds available to American controlled shipping by subjecting shipping income targeted for reinvestment in the business to current taxation -- while foreign owners have continued to be able to use their tax deferred or, in some cases, tax free income to modernize and expand their fleets.

The results of disadvantaging American controlled shipping in such a fashion were summarized by the Price Waterhouse survey on the impact of the 1986 Act, as follows:

> "The survey results show that U.S. ship acquisitions have been reduced, use of foreign owned vessels has increased, and that a portion of the U.S. controlled fleet has been sold to foreigners. Thus, the net effect of the 1986 Act has been to diminish the competitive position of the U.S. fleet."

B. Impact on American Maritime Infrastructure

As American investment in open registry shipping has declined and as the business has shifted to foreign owners unaffected by the 1986 Act, private sector jobs and expertise have been whittled away not only from the American-based vessel operating companies which have either retrenched or left the maritime sector entirely, but also from the broad range of support services that make up the maritime infrastructure in the United States. These services include naval architecture, vessel classification and surveying, ship sales and purchase brokerage, cargo brokerage, marine insurance, admiralty and maritime law, marine accountancy, ship finance, ship management, maritime consulting, maritime arbitration, and various other specialties linked to the maritime sector.

The nature of the maritime business is that shipping companies tend to retain the maritime support services located in their own country, relying on persons with whom they are familiar in business and sometimes social relationships. Consequently as American investments in open registry shipping have waned, so have the demands for services of Americans offering such support services.

A warning of what was happening to the maritime services sector was publicly voiced at a New Orleans conference in September 1989 by William P. Sauer, a preeminent American ship sales and purchase broker operating out of Florida. He said:

> "As an American shipbroker dealing with United States controlled shipping companies, I am deeply concerned with the increasing number of companies that have moved their offices offshore and the amount of joint venturing of American controlled companies with foreign shipping companies. These factors will not only reduce the number of companies for whom we may be able to transact business, but they are also dissipating our country's international shipping infrastructure, of which I have been a participant for more than 45 years. In my view, this is an unfortunate and unnecessary waste of a national strength. These offshore moves have been the result of the present American tax laws which have effectively disadvantaged American controlled companies..."

As a postscript, it is noteworthy that some months ago the continuing retrenchment of American controlled shipping caused Mr. Sauer to shut down his brokerage business and terminate his support staff.

It is also noteworthy that in April 1993 the Shipbuilders Council of America, representing U.S. shipyards performing ship construction, conversion and repair, publicly supported reinstatement of Subpart F deferral, doubtless recognizing that a revitalized American controlled open registry fleet could be a positive factor in their efforts to compete in the international commercial arena. The shipbuilders group stated in part:

> "It is time that the U.S. tax system be changed to encourage, rather than discourage, American business from making long term, productive capital investment, including reinstating the shipping reinvestment rule for American shipowners. Such a move would be supported vigorously by American shipyards."

The nation's maritime infrastructure and the expertise that it entails are vital national assets especially in time of national emergency, and also provide shoreside employment opportunities for thousands of Americans. Restoration of Subpart F reinvestment deferral would aid substantially in revitalizing the maritime infrastructure in the United States.

C. Impact on Tax Revenues

Based on what is known empirically and anecdotally about the continuing decline of American controlled open registry shipping and its ripple effect on the maritime infrastructure in the United States, there is good reason to believe that the overall impact of the elimination of reinvestment deferral under Subpart F on tax revenues has been increasingly negative, and that the negative impact will continue unless reinvestment deferral is restored. In this regard, we urge your Subcommittee to request the Treasury Department to analyze Subpart F shipping tax revenues produced in the past few years and to compare such revenues to tax revenues produced in years prior to 1987. We believe that the results of such a comparison will indicate that restoration of reinvestment deferral would enhance, not detract from, future tax revenues.

Some years ago the General Accounting Office (GAO) reported that Subpart F shipping tax revenues for 1987, the first effective year of the 1986 Act, aggregated about $47 million, actually less than the $50 million in revenues which the GAO reported was produced in 1984 by reinvestment deferral (and higher tax rates). Since 1987, as discussed earlier, the American controlled EUSC fleet has declined sharply, thereby presumably dampening the potential for future tax revenues.

The 1984 revenues underscore the basic consideration that deferral on shipping income is not tax forgiveness but rather tax postponement which, depending on each taxpayer's reinvestment program, should sooner or later produce taxable income, assuming that market and other conditions are favorable. It should be kept in mind that tax deferral on income of American controlled shipping companies, according to published data, did generate considerable taxable income in earlier years.

A 1976 Treasury Department staff study ("Tax Treatment of Income From International Shipping," Essays In International Taxation: 1976, 97 (The Department of the Treasury, Washington, D.C.)) sampled 1973 tax returns for American companies controlling foreign flag shipping corporations representing two-thirds of the total gross tonnage of such ships. This study reported that $257 million (approximately 39% of the shipping earnings and profits for that year) were, in fact, remitted to U.S. taxpayers and thus presumably were subject to U.S. tax. (Notably this was before the 1975 Act which made even unremitted shipping earnings and profits subject to U.S. income taxation unless they were reinvested in shipping assets.)

A 1976 study by the Department of the Treasury's Office of Tax Analysis estimated that the partial elimination in 1976 of U.S. income tax deferral on the earnings and profits of U.S. controlled foreign shipping corporations provided actual revenue of $35 million in federal income taxes for the 1976 tax year. ("U.S. Taxation of the Undistributed Income of Controlled Foreign Corporations," Essays In International Taxation: 1976, 39 n.3 (The Department of the Treasury, Washington, D.C.))

Thus, based on available sampling and studies, there is reason to believe that the deferral of U.S. tax on American controlled shipping did result in positive contributions to the U.S. Treasury in the form of federal income tax revenues prior to the 1986 Act.

From the standpoint of sound tax policy it would seem that such a result is much more desirable than that produced by the elimination of reinvestment deferral in the 1986 Act, which was essentially a message to American shipowning companies that they could no longer expect to compete with foreign owners on a level playing field.

D. Impact on National Defense

There are readily identifiable national security interests in preserving and promoting a significant American ownership presence in international shipping. Certainly paramount is the need to have ample privately owned merchant vessels subject to call by U.S. defense authorities in time of war or national emergency in order to provide both direct and indirect support to the armed forces and to maintain the flow of critical raw materials needed to fuel the American economy under emergency conditions. A corollary interest is to maintain in this country an adequate maritime infrastructure of companies and personnel with the highly specialized expertise and experience need to build, operate, maintain, manage and otherwise service merchant vessels under emergency conditions.

Even if national emergency contingency needs are not taken into account, there can be little doubt that the national interest would be better served by encouraging and maintaining American control over a significant segment of oceanborne transportation services upon which trade and commerce with other nations is dependent, rather than abandoning these trades to essentially foreign domination and control. A healthy American presence can be justified by a number of ancillary considerations, including future tax revenues, control over future energy transporation, enhanced environmental protection, antitrust regulation, the balance of payments, and economic opportunities for American firms and their personnel providing specialized maritime services such as brokerage, insurance, ship classification, ship management, ship finance, law, accounting, etc.

Under ideal conditions the privately owned vessels would be commercially viable, be owned and manned by Americans and be registered in, and thus fly the flag of, the United States. However, the real world of international competition in no way approximates these ideal conditions. Regrettably, the bottom line is that U.S. flag vessels have much higher costs than competitive foreign vessels, and thus there are virtually no domestic flag vessels which can compete head to head in the international arena with foreign owned vessels in the absence of direct or indirect subsidies.

Consequently, over the course of the century U.S. flag vessels operating outside the protected domestic trades (where foreign flag competitors are barred by law) have had to rely on funding by U.S. taxpayers to maintain even a minor presence in the international trades. This funding has taken various forms, including operating subsidies, mortgage insurance, carriage of military cargoes, guaranteed shares of agricultural aid cargoes and charters to the Military Sealift Command, and has aggregated hundreds of millions of dollars each year in expenditures from the U.S. Treasury. Such funding is subject to obvious budgetary and other constraints.

Faced with this reality, defense planners have looked beyond the optimum and, based on a policy formulated by the Joint Chiefs of Staff following World War II, relied on additional emergency sealift coverage from internationally competitive Effective U.S. Control (EUSC) vessels. These are ships which are beneficially owned and operated by American companies and which presently fly the flags of Liberia, Panama, Bahamas, and The Marshall Islands.

EUSC policy arose out of the problems created by the Neutrality Act of 1939 which barred U.S. flag ships from carrying essential supplies to Great Britain and France prior to our entry into the war and the subsequent substantial contribution the American controlled vessels made as part of the war effort. The policy has been tested not only in the Second World War but also indirectly in Korea (under the Voluntary Tanker Tonnage Plan) and during the Viet Nam conflict (on a commercial basis).

The most recent reaffirmation of reliance on EUSC shipping occurred on October 5, 1989 when the President approved the National Security Sealift Policy prepared by the National Security Council. The NSC released an unclassified summary of the Policy which states that "sufficient military and civil maritime resources will be available to meet defense deployment, and essentially economic requirements in support of our national security strategy." The summary lists policy guidelines approved by the President, including the following:

> "First, the US-owned commercial ocean carrier industry, to the extent it is capable, will be relied upon to provide sealift in peace, crisis, and war....
>
> "Secondly, we must be prepared to respond unilaterally to security threats in geographic areas not covered by alliance commitments. Sufficient US-owned sealift resources must be available to meet requirements for such unilateral response.
>
> "Thirdly, in addition to the US flag fleet we will continue to rely on US-owned and allied shipping resources to meet strategic commitments to our established alliances. The Department of Transportation is responsible for ensuring that the appropriate control over 'effective U.S. control' ships are in place..." (Emphasis added.)

EUSC vessels offer some unique advantages as a supplement to available U.S. flag tonnage. They are not subject to federal budgetary constraints. They are, for the most part, in active service and at any given time are dispersed throughout the world, with many deployed in the U.S. import/export trades. Unlike NATO vessels, they are controlled and operated by American companies, which have supported this policy since its inception, and thus their availability is not problematic in emergencies where U.S. actions conceivably might not be supported by its NATO partners.

For national defense reasons alone, maintaining the international competitiveness of the EUSC fleet makes eminent good sense.

E. Position on Proposals To Restore Reinvestment Deferral

We fully support the proposal before your Subcommittee that presumably would restore reinvestment deferral to all American shipping companies with controlled foreign shipping corporations. We further believe that such restoration should be dependent on a binding contractual commitment to make such vessels available to the United States for requisition, use or charter in event of war or national emergency. These contractual commitments would serve a significant national defense interest by reaffirming, clarifying and facilitating the statutory rights of requisition, use or charter in the 1939 amendment to Section 902(a) of the Merchant Marine Act of 1936.

The other proposal before your Subcommittee would pick and chose among American companies by limiting restoration of reinvestment deferral only to those companies which operate minimum U.S. flag fleets of at least four vessels of at least 10,000 tons each. Certainly we are in accord with the fundamental premise underlying this proposal which is that reinvestment deferral is necessary for the continued competitive viability of the companies in international shipping. But we see no rational reason why restoration should be limited to companies with minimum U.S. flag fleets, while denying such relief to American companies operating EUSC vessels but not meeting the minimum domestic fleet level. We believe that such a limitation would be unfair and discriminatory, and would be unsound from the standpoint of U.S. maritime policy.

There is little, if any, interrelationship between American controlled EUSC vessels and U.S. flag vessels. The EUSC vessels must compete against foreign controlled vessels in the intensely competitive global marketplace without benefit of any direct or indirect U.S. subsidies. There are some U.S. flag ships which trade internationally, but they do so only because of hundreds of millions of dollars paid annually by U.S. taxpayers in the form of (1) operating subsidies averaging about $3 million per ship per year, (2) exclusive entitlement to carry U.S. military cargoes and (3) guaranteed shares of government generated or financed cargoes at premium rates much higher than world market rates. The remaining U.S. flag commercial fleet operates in the domestic or cabotage trades where competition from foreign flag vessels is prohibited by law, thus creating a supply/demand equation and a rate structure unrelated to the international marketplace.

Thus, EUSC ships and U.S. flag ships rarely, if ever, would be operating in the same trades and competing against each other. Some American companies with EUSC vessels (perhaps as many as half of the EUSC companies) have concentrated their maritime operations exclusively in the international nonliner commercial trades and thus would have no reason to become involved in U.S. flag operations.

Nor could these EUSC operators readily become U.S. flag operators in order to qualify for reinvestment deferral under the proposal. The operating subsidy program has been generally limited to liner vessels (plus a very limited number of bulk vessels built under a 1970 law). Even more significantly, the subsidy program itself has been frozen for many years and is presently being phased out for lack of funding. At the same time, military cargoes are declining and government cargo preference programs are of minor significance. A similar barrier exists in the domestic trades. The demand for cabotage tonnage is contracting, and new opportunities for investment are virtually nonexistent.

In short, the realities facing any American company with EUSC vessels but without a minimum fleet of four U.S. flag vessels are that opportunities for obtaining direct subsidies are nonexistent, guaranteed cargoes are very limited, and in the cabotage trades available cargoes are both limited and declining.

Consequently, the proposed minimum U.S. flag fleet limitation would reward only those having fleets unrelated to the marketplace in which EUSC ships must compete, and whose U.S. flag vessels have received the benefit of either taxpayer funding or protected trades. At the same time the proposed limitation would unfairly deny relief to EUSC owners who have no meaningful economic opportunity to meet the proposed minimum and arbitrary fleet level.

In terms of fashioning a sound U.S. maritime policy, the concept of establishing a minimum fleet size of four vessels makes very little sense. The companies with larger U.S. flag fleets would be under no incentive to maintain their fleet sizes, other than not to reduce their U.S. flag fleet levels below four vessels. A few companies with very small U.S. flag fleets might be encouraged to maintain or attain the minimum level, but in the final economic analysis even those decisions would ultimately be made on the basis of the availability of direct or indirect subsidies and/or a need for tonnage in the cabotage trade.

During deliberations on the 1986 Act there were those who believed that the elimination of reinvestment deferral would prompt American companies to transfer their EUSC vessels to U.S. registry -- even though the cost differentials of millions of dollars per ship per year clearly made such decisions economically impossible. The empirical evidence is that in the years following enactment of the 1986 Act not a single EUSC ship was so transferred to U.S. registry. Ships were instead scrapped or sold or otherwise transferred to foreign ownership and control. The proposal to link restoration of reinvestment deferral to minimum U.S. flag fleet levels is clearly grounded on an equally erroneous premise. Its limitation should be removed so that all American companies are treated fairly, and are not discriminated against arbitrarily and unrealistically.

II. CARRYFORWARD OF PRE-1987 LOSSES

Your Subcommittee's review of the proposal to remedy the denial of pre-1987 loss carryforward is most welcome. In our opinion, this issue presents a clearcut case of tax inequity which should be rectified. International shipping markets are keyed to supply of and demand for vessels and thus are high risk and cyclical in nature, with recurring peaks and valleys with respect to profits and losses. The effect of disallowing the carryforward of pre-1987 CFC shipping losses is that the U.S. shareholders of shipping CFCs have been taxed on post-1986 income without the benefit of an offset for the actual economic losses incurred during the years which set the stage for present profitability. The pre-1987 losses for the most part were attributed to a deep and prolonged recession primarily in the bulk sector of the shipping industry and were not the result of tax incentives such as ACRS and the investment credit which generally were not available to investments in EUSC ships.

The imbalance and inequity generated by this rule are further demonstrated by the consequences resulting from the sale of assets held during loss years. Ships are often held for the purpose of producing future profits from operations or sales and therefore they may have to be held through extended loss periods in order to realize eventually the long-term values of the assets. By imposing current taxation, the 1986 Act effectively is taxing the profit which a shipowning company obtained only because it had the foresight -- and the courage -- to hold the asset while it generated current losses.

Because the 1986 Tax Act does not permit an offset for a shipping deficit incurred prior to 1987, it has, in effect, denied a deduction for all or a portion of the costs of carrying the ship during the loss years. This approach, when applied over the years that a given vessel is operated, could more closely approximate the imposition of tax on gross income rather than net income.

These results seem particularly draconian when one considers how even straight line depreciation can be rendered meaningless for American controlled companies seeking to compete in one of the world's most capital intensive enterprises. Consider a situation where gain is realized on the sale of a ship held in loss years prior to 1987. A portion of the gain is necessarily attributable to depreciation allowed during those years. Not only is the deduction for this depreciation lost under the rule denying the carryforward of pre-1987 losses, but also the gain on the sale of a ship after 1986 includes an amount equal to that depreciation -- a result tantamount to double taxation. In some cases a tax could conceivably be imposed where there actually is no income at all.

CFCs which took advantage of the reinvestment provision merely postponed current recognition of such income, and are not assured

permanent deferral. Since 1975, taxpayers which made qualified reinvestment of shipping income have been required to maintain separate accounts of the amounts reinvested. Any amount withdrawn from these accounts, including amounts withdrawn after 1986, are required to be included in income under Subpart F. Therefore, allowing the pre-1987 CFC shipping losses to be carried forward against post-1986 CFC shipping income can and should be distinguished and treated differently from other situations where the carryforward of losses was disallowed.

For these reasons we urge that Congress remove the restrictions on carrying pre-1987 deficits forward against post-1986 shipping income of the CFC. This change is a matter of fundamental tax equity. It would represent an important step toward ameliorating the unduly harsh tax treatment in the 1986 Act.

CONCLUSION

We urge your Subcommittee to support the proposal to restore Subpart F reinvestment deferral to all American shipping companies, and also to support the proposal to permit carryforward of pre-1987 shipping losses.

Statement of E. Clay Shaw, Jr.,
Before the Subcommittee on Select Revenue
June 24, 1993

A 1986 change in the tax code imposed an immediate U.S. tax on the income of U.S. controlled foreign shipping companies, regardless of whether the income is reinvested in or repatriated to the U.S. United States taxation of its shipping operations is now the harshest of any major maritime nation. Foreign-controlled vessels operate virtually tax free. This 1986 change in the U.S. tax law put United States-controlled shipping operations at an extreme competitive disadvantage.

Since 1986, the U.S. controlled fleet has been shrinking at an alarming pace. The U.S.-controlled "open registry" fleet has declined 42 percent while our foreign competitors expanded their fleets by 33 percent. Furthermore, U.S. controlled shipping companies now carry less than 25 percent of our total waterborne trade and only nine of the top 100 carriers of containerized cargo serving the United States are U.S. controlled.

U.S. controlled shipping operations, which are vital to international trade and national defense, are near extinction and with them the countless jobs associated with the industry. Within the decade, the United States --the world's largest trading nation-- will be unable to move on U.S.-controlled vessels what it buys and sells if U.S. tax policy is not corrected. Increased trade from the NAFTA and GATT agreements (95 percent of which will move by sea) will be operated almost exclusively by foreigners.

Reinstatement of the rule under which U.S.-controlled shipping companies pay U.S. tax on reinvested income when repatriated to or invested in the U.S. will begin to "level the playing field" with foreign competitors and reverse the decline of the U.S.-controlled fleet. This is not a tax exemption; all income would be taxed when repatriated to or invested in the United States.

U.S.-controlled shipping companies use U.S. shipyards, which are also ailing, to build and repair their ships. Ship repair and construction means additional jobs in U.S. yards, which is particularly critical as the defense budget shrinks.

Moreover, U.S.-controlled foreign shipping companies and their U.S. parent corporations directly employ thousands of U.S. workers. There are substantial American businesses that sell goods and services to these shipping companies. Competitive and expanded U.S.-controlled foreign shipping would save existing and create new U.S. jobs.

Furthermore, U.S. controlled foreign shipping companies promote U.S. trade and have helped create a favorable balance of trade in the Caribbean Basin. Many of the businesses trading in this region use U.S.-controlled shipping companies, both for the reliability of the service and because they effectively steer businesses to U.S. companies.

Lastly, ships owned by U.S. controlled foreign shipping companies are Effective U.S. Controlled vessels which can be requisitioned by the United States Government in times of national emergency.

Mr. Chairman, I thank you and the Subcommittee for your time and consideration of this issue.

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June 24, 1993

VIA HAND DELIVERY

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue Measures
House Committee on Ways and Means
1105 Longworth House Office Building
Washington, D.C. 20515

Re: June 24, 1993, Hearing on Proposal To Reinstate Reinvestment Rule for Shipping Income of Controlled Foreign Corporations

Dear Mr. Chairman:

This statement is submitted for the record of your June 24, 1993, hearing on the above-referenced proposal. I am writing in my capacity as Vice Chairman of Birdsall, Inc. ("Birdsall"), a U.S. corporation which owns 100 percent of the stock of Tropical Shipping & Construction Co., Ltd. ("Tropical"), a Bahamian shipping corporation.

Tropical was established thirty years ago when my father bought a small "Roll-on Roll-off" vessel from a Tampa shipyard and initiated a service to carry construction materials and equipment between South Florida and the Bahama Islands. Since then, Tropical has become a major carrier in the Caribbean region. The company owns 14 container ships and serves 23 locations throughout the Bahamas and the Caribbean Basin. Last year, through Tropical, Birdsall transported more than a billion dollars worth of various U.S. exports to the Caribbean basin, competing against both foreign- and other U.S.-owned carriers.

Our fourteen vessels are engaged in a liner-type service -- meaning they depart for various destinations on a fixed schedule from Riviera Beach, Florida, where we maintain substantial terminal facilities for the receiving, handling and loading of cargoes. We also operate a cargo depot in Miami, Florida, and through agency relationships, maintain cargo-receiving locations in Roselle Park, New Jersey and Houston, Texas. Birdsall, Inc.'s headquarters are in Riviera Beach, and we employ over 500 people in the South Florida region.

U.S.-Owned Shipping Operations Cannot Continue To Compete with Foreigners Under Current U.S. Tax Law

Despite our past success, Birdsall's ability to continue competing with foreign owners under the current tax rules is seriously threatened. From the time we started our business until 1975, we were taxed, like our foreign competitors, only when shipping income was repatriated. In 1975, however, we were placed at a disadvantage when shipping income which was not reinvested in shipping assets was included in Subpart F. That disadvantage became much larger in 1986, when U.S. owners were subjected to an immediate U.S. tax on the shipping income of their controlled foreign corporations, regardless of where or how the income is used. The current rules are unquestionably the harshest of any major maritime nation. Our foreign competitors either pay no tax or are permitted to defer tax indefinitely. This means that since 1986 we are subject to an immediate tax of 34 percent while our competitors pay no current tax.

B
GENERAL SHIPS AGENT, STEVEDORE, ICC CARRIER

Birdsall, and, I believe, others, cannot compete under this yoke. In the six years since the law was changed, U.S.-owned shipping companies operating international flags have lost a significant portion of their markets, shrinking over 40 percent relative to our competitors. Several prominent industry members -- for instance, Carnival Cruise Lines (a passenger line) and Skaarup Shipping (a bulk operator headquartered in Greenwich, Connecticut) -- have either sold majority interests in a sizable portion of their fleets to non-U.S. persons or otherwise "decontrolled" their operations in order to maintain their companies' ability to compete. Unless Congress corrects this problem soon, Birdsall will be forced to sell out to foreign competitors who operate free of any current income tax.

I am also convinced that, if Congress fails to act, other U.S.-owners will have no choice but to follow suit. When that happens, foreigners will control who carries all U.S. imports and exports and, as a result, will wield substantial control over our country's economic well-being. This would be particularly ironic given that international trade is expected to expand significantly when new trade agreements take effect. The likelihood is that U.S.-owned shipping operations will carry almost none of that increased trade. Whatever the original motivation for the current tax rules, it does not make sense to continue this trend and concede carriage of our waterborne trade to foreign control.

The devastating impact of the 1986 tax change has been decried in newspapers from around the country. Two examples, an April 26, 1993 editorial in the Tampa Tribune and a commentary by economist Gary Hufbauer published on the same date in the Journal of Commerce, are attached to my statement.

I note with particular concern the June 22, 1993, statement by Assistant Secretary Samuels that it "would be premature to propose any change in these rules at this time" because "an inter-agency task force is reviewing our shipping program". The last Administration took a similar position that further study was required. With all due respect, evidence of the harm caused by the repeal of the reinvestment rule is clear and convincing. See, for example, the attached Price Waterhouse study. By the time additional Administration studies are done, Tropical and others will be in foreign hands. The time to act is now!

Restoring the Reinvestment Rule Will Begin To Level the Playing Field and Permit U.S.-Owned Shipping Operations To Compete

Two proposals that begin to level the playing field are currently before the Ways and Means Committee. The first, advanced by Congressman Shaw, would restore the tax law in effect between 1975 and 1986 by permitting U.S. owners to pay tax on the shipping income of their controlled foreign corporations when repatriated, so long as the income is reinvested in qualified shipping assets (the "reinvestment rule"). The second, proposed by Congressman Jefferson, would provide the same treatment, but only with respect to owners that operate at least four U.S. flag ships of 10,000 deadweight tons or more.

Either income reinvestment proposal would go a long way towards putting U.S.-owned shipping operations back on a competitive footing, and Birdsall is grateful for the interest and concern of Congressmen Jefferson and Shaw. We strongly support both proposals, with two important qualifications:

(1) Caribbean Concerns. Birdsall cannot satisfy the four large U.S. flag ship requirement. Tropical

does not operate any ship as large as 10,000 deadweight tons because such ships are too large to be used economically in the Caribbean market, and many Caribbean ports will simply not accommodate vessels of such deep draft. Similarly, because the additional costs associated with U.S.-flag vessels make them uncompetitive in the region, neither Tropical nor any other owner operates any U.S.-flag vessel in the common-carrier foreign trade to the Caribbean. Accordingly, imposing this four large U.S. flag ship requirement would effectively discriminate against those U.S.-owners that operate in Caribbean trade. Not only would that be grossly unfair, it would be ironic given that the Caribbean is the one region where the U.S. has dominated waterborne trade.1/ Thus, any reinstatement of the reinvestment rule that is so conditioned must include an exception for operations primarily in the Caribbean.

(2) Effective U.S.-Control Clarification. Both pending proposals would also limit relief to vessels available to the U.S. government in times of national emergency. We support this condition and would willingly cooperate with the government should a need arise. However, the description of the proposals by the staff of the Joint Committee on Taxation, contained in JCS-8-93, states that reinstatement would be available to those who "agree to make [their ships] available." This language is ambiguous. Presumably, it is intended only that owners be willing to make their ships available under the normal Effective U.S. Control ("EUSC") agreement with the Department of Defense. However, an owner's ability to take advantage of the reinstated reinvestment rule should not depend upon the existence of such an agreement. Such a requirement would give the Department of Defense effective control over which owners benefit from the rule by simply declining to enter such an agreement or rescinding one in effect.

Conclusion

If Congress restores the reinvestment rule, I am confident that Birdsall will not only hold its own, but also expand its operations. More generally, reinstating the reinvestment rule will permit the U.S.-owned fleet to save itself from foreign acquirors and to participate in expanding world trade. These opportunities will all disappear, however, if Congress waits much longer to reinstate the reinvestment rule.

Respectfully,

J H Birdsall

John H. Birdsall, III

1/ It is no coincidence that the Caribbean is also one of a very few areas where the U.S. maintains a favorable balance of trade. U.S. carriers act as salesmen for U.S. exports in an effort to increase the demand for their shipping services. Foreign owners who replace the likes of Birdsall are more likely to market exports from their own nations, and thus further erode our balance of trade.

THE TAMPA TRIBUNE

The Tampa Tribune, Monday, April 26, 1993

EDITORIALS

Fair play for U.S. shipping

The American shipping industry is sinking. Since 1986, the U.S.-owned registry fleet has declined by 42 percent. Foreign-owned shipping companies carry more than 75 percent of America's waterborne trade.

The scuttling of the ship industry has eliminated thousands of job, hurt hundreds of related businesses and cost the nation millions of dollars in local, state and federal tax revenues.

While a number of factors may be involved, there is no doubt that the major culprit is the federal tax revision of 1986.

It is another case of how government meddling, and money-grabbing, throttles American competitiveness.

Some background:

In the Tax Reform Act of 1986, Congress killed the tax deferral on the foreign earnings of the U.S. shipping fleet. Previously, companies had been able to defer foreign shipping income that was reinvested in fleet improvements. The elimination of the deferral, which slipped through the House with no debate, was supposed to raise $40 million a year.

Instead, it virtually scuttled the industry. The reason? Foreign countries do not tax the foreign earnings of their shipping corporations.

Companies in the capital-intensive shipping industry now must set aside about a third of their income for U.S. taxes before they can put money back into their fleets. Not surprisingly, they are dead in the water in global competition.

None of America's shipping competitors, which include Japan, Taiwan, Britain, Norway, Germany and Greece, must meet such an expense. In other nations, the shipping industry is either untaxed or tax-deferred.

Studies by the Institute for International Economics, the Massachusetts Institute of Technology, Price Waterhouse and even the government's General Accounting Office document how the elimination of the deferral instigated the decline of the U.S. fleet.

The solution is simple. Restore the deferral. This would not represent a tax break. It would simply allow companies to defer paying taxes on income that is used for maintenance and expansion.

The change would cost the federal treasury little, since the tax has not generated nearly what was expected.

The 1991 MIT study, which was funded by the shipping industry, concluded, "The cost to the U.S. society of helping the U.S.-owned flag fleet is probably zero or close to it, since tax revenues from the industry segment have actually decreased since the passage of this act."

Indeed, without a tax revision, the nation's fleet likely is doomed, and with it many ancillary businesses.

Important, too, is that the return of the tax deferral would bolster the nation's anemic shipbuilding industry, since it would give shipowners an incentive to use U.S. shipyards for maintenance and drydocking. This obviously would help Tampa's shipbuilding industry and generate more local jobs.

But there is more than parochialism involved. If the United States is to remain a economic powerhouse, if it is to be internationally competitive, and if it is to stop the exporting of American jobs, it must put an end to foolish and self-destructive policies and taxes. Congress can begin the march to economic sanity by reviving the tax deferral for the shipping industry.

The Journal of Commerce

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EDITORIAL/OPINION

Hurried Tax, Vanishing Ships

By GARY HUFBAUER

As Congress struggles with the first Clinton budget, it should recall a lesson from 1986 when members last wrestled with major changes in the U.S. tax system. The Congress presumably did not want to tax the U.S. oceangoing shipping fleet out of business. In 1986, it just wanted to raise a little extra money. But Congress forgot the laws of international competition. The result was to push the U.S.-controlled shipping fleet rapidly toward extinction.

Arthur Laffer may have claimed too much for his famous curve when he argued that lower tax rates would raise U.S. tax revenues across the board. Yet Mr. Laffer was surely right. In important instances, higher tax rates actually curtail the amount of tax collected. This happens because the tax base shrinks as employees and owners play avoidance games, reduce their work effort or simply go out of business.

In the Tax Reform Act of 1986, the U.S. Congress managed to enact a tax that vindicates Mr. Laffer's basic proposition. In its last minute rush to balance the revenue figures (if only on paper), Congress enacted a gaggle of complex foreign tax provisions, all designed to squeeze revenue out of offshore activities, most of them misguided.

Among these measures, the most conspicuous failure was the tax on foreign earnings of the U.S.-controlled shipping fleet. According to a General Accounting Office study, the new shipping tax miserably failed to raise the revenue promised — an additional $160 million to $240 million over five years, or about $40 million a year. Instead it nearly sank the last vestiges of the U.S.-controlled merchant fleet.

While the tax details are mind-numbing and mainly of interest to chronic insomniacs, here are the facts.

- Before 1986, under Subpart F of the U.S. Revenue Code, U.S.-controlled ships paid U.S. tax on their foreign earnings at the normal corporate rate *unless* it was reinvested in certain qualified shipping assets. If it was reinvested, taxes were deferred until the investment was withdrawn.
- But in 1986, the United States repealed this deferral — it was not forgiveness — of U.S. taxes for earnings reinvested in the shipping industry.

This change was rushed through Congress in 1986 on the superficial grounds that shipping should be taxed like any other industry. The problem is that shipping is not any other industry.

U.S.-controlled ships compete for cargo with ships controlled by Taiwanese, Danish, British, German, Norwegian, Japanese, Greek and other owners. The shipping industry is highly capital intensive, so collection of the U.S. tax, whether or not earnings are reinvested, significantly adds to the cost of doing business. While the details of foreign tax codes are almost as mind-numbing as the U.S. Revenue Code, the bottom line is exceptionally simple: Foreign countries simply do not tax the foreign earnings of their shipping corporations.

Hence, since repeal of the reinvestment rule in 1986, the U.S.-controlled fleet has operated at a significant cost disadvantage by comparison with its foreign competitors – not because it is less efficient but purely as a result of hasty U.S. tax rules.

The outcome is not surprising. Shortly after the United States repealed the reinvestment rule and started to tax its merchant ships, the U.S.-controlled fleet began to vanish. Between 1986 and 1991, the U.S.-controlled fleet dropped from 17.1 million gross tons to 12.3 million gross tons, a decline of 28%. The problem was not a shrinking shipping industry worldwide. During this same period, the open world fleet rose from 126 million gross tons to 157 million gross tons, a rise of 25%. Today, only 14 of the top 100 container carriers that transport general cargo in the U.S. foreign trade are still U.S.-owned or controlled.

With quick action, the endangered U.S.-controlled fleet can be saved. Congress can undo the damage inflicted in 1986 by a simple step: reinstate the reinvestment rule. Since the 1986 law raised little revenue, its reversal should cost the government very little. But if a careful evaluation shows that an offsetting revenue pickup is needed, there is one way that taxes might be gathered without decimating the U.S. shipping industry.

A very low-rate excise tax on gross tonnage could be imposed on all vessels clearing U.S. ports, whatever the flag and whatever the ownership. For example, a tax of 10 cents per ton would raise approximately $50 million annually. There is no such thing as a perfect tax, but a 10 cent tonnage tax, coupled with the reinvestment rule for the U.S.-controlled fleet, would at least solve the problem of vanishing ships and disappearing revenue.

Gary Hufbauer is a senior fellow at the Institute for International Economics in Washington and former director of the international tax staff of the Treasury Department.

DECLINE IN THE U.S.-CONTROLLED SHARE OF THE OPEN REGISTRY MERCHANT SHIPPING FLEET SINCE 1986

by

Price Waterhouse

June 24, 1993

Introduction

The Tax Reform Act of 1986 ("1986 Act") made significant changes in the tax rules applicable to all corporations, such as the reduction in the corporate tax rate and the repeal of the investment credit. The 1986 Act also substantially revised long-established rules governing the taxation of international shipping income. In particular, the 1986 Act repealed the exception to subpart F for reinvested shipping income, which effectively makes that income subject to immediate U.S. tax regardless of whether it is reinvested in shipping assets. The 1986 Act also modified the source rules to increase U.S.-source income, disallowed pre-1987 accumulated deficits, and established a separate foreign tax credit limitation for shipping income.

While the 1986 Act was intended to improve the performance of the U.S. economy, the Act creates a competitive disadvantage for U.S. companies controlling vessels registered abroad, and encourages the transfer of vessels from U.S. control to foreign owners. Indeed, since 1986, the U.S. share of the world open-registry fleet has declined by 42 percent. This precipitous loss in market share has adverse consequences for both U.S. competitiveness and U.S. emergency sealift capacity from the Effective U.S. Control (EUSC) fleet.

U.S. Taxation of International Shipping Income

As a result of the enormous investments required to modernize and expand fleet capacity, the cost of capital is critical to the competitiveness of U.S. shipowners in the world market. Until the 1986 Act, the international shipping income of U.S. shipowners was taxed in a manner generally comparable to the taxation of income of foreign shipowners. The 1986 Act, however, substantially revised long established rules governing the taxation of international shipping income, raising the cost of capital to U.S. shipowners.

Most prominently, the 1986 Act subjected foreign base company shipping income reinvested in qualified shipping assets to current taxation, reducing internal funds available to U.S.-controlled foreign shipping corporations for fleet modernization. The 1986 Act also eliminated certain loss carryforwards, made more transportation income U.S.-source income, and established a separate foreign tax credit limitation for foreign shipping.

Foreign country tax rules

While the United States has sought to increase the current tax payable by U.S.-controlled foreign shipping companies, the tax laws governing foreign competitors have been more accommodating. Among the more favorable tax rules provided by foreign competitor jurisdictions are:[1]

- Taxation of income earned by controlled foreign shipping companies only when repatriated.
- Use of losses generated in international shipping activities by controlled foreign shipping corporations to reduce income from other sources; and
- Deferred income recognition provisions, including: highly accelerated methods of depreciation; deduction of reserves on account of anticipated future expenses; deferral of tax on gain from the sale of ships; and deduction of construction-period interest.

In comparison with the tax laws of other countries, U.S. tax rules usually result in a higher cost of capital for U.S.-owned vessels.

Effect of the Tax Reform Act of 1986

International shipping is a highly competitive, capital-intensive industry. Most cost items -- crew, fuel, repairs, debt service, etc. -- are similar among international competitors except for the income taxes imposed by the shipowner's country of residence. Difference in tax treatment between the United States and other countries can result in a significantly higher cost of capital for U.S.-owned vessels.

U.S. carriers have responded to the increased cost of capital resulting from the 1986 Act in a number of ways. U.S. ship acquisitions have been reduced, use of foreign owned vessels has increased, and a portion of the U.S. controlled fleet has been sold to foreigners.[2] The net effect of the 1986 Act, therefore, has been to diminish the competitive position of the U.S. fleet.

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[1] See Price Waterhouse, *Taxation of the International Maritime Industry: A Comparative Study*, February 1990.

[2] See Price Waterhouse, *Survey of American Controlled Shipping*, January 1990.

The U.S. open-registry merchant fleet has declined substantially in recent years both in absolute size and relative to the world market. Between 1986 and 1991, the U.S. share of the world open-registry merchant fleet decreased by more than 40 percent. As shown in Table 1, in 1986 the world open-registry fleet was equal to 126 million gross tons, of which 17 million gross tons (or 13.6 percent) was U.S.-owned. By 1991, the world fleet had *increased* to 157 million gross tons, while the U.S. fleet *decreased* to 12 million gross tons, causing the U.S. share to fall to 8 percent.

Conclusion

The changes in the taxation of international shipping income under the 1986 Act increased the cost of capital of U.S. shipowners relative to their foreign-based competitors. The repeal of the exception to subpart F for reinvested shipping income has been particularly burdensome. As a result of the highly competitive and capital-intensive nature of the international maritime industry, these changes would be expected to decrease the competitiveness of U.S. shipowners. Data on the industry for the 1986-1991 period confirm this result: the U.S.-owned open registry fleet has declined from 17 to 12 million gross tons, representing a 42% decline in the U.S. share of the world market. This decline cannot be attributed to weakness in the shipping industry as worldwide capacity increased from 126 to 157 million gross tons over this period.

Table 1
Open Registry Merchant Fleet: 1986–1991
[In thousands of gross tons]

	Year		*Change, 1986–1991*	
Ownership by registry	*1986*	*1991*	*Absolute*	*Percentage*
Total (U.S. and foreign owned):				
Bahamas	5,985	17,541	11,556	193.09%
British Dep. Ter.	12,928	13,809	881	6.82%
Cyprus	10,617	20,298	9,681	91.18%
Honduras	555	816	261	46.96%
Liberia	52,649	52,427	(223)	-0.42%
Malta	2,015	6,916	4,901	243.25%
Panama	41,305	44,949	3,644	8.82%
World Subtotal	126,054	156,756	30,702	24.36%
U.S.-owned:				
Bahamas	2,075	2,547	472	22.77%
British Dep. Ter.	752	1,561	809	107.67%
Cyprus	2	0	(2)	-100.00%
Honduras	23	6	(17)	-72.01%
Liberia	11,360	7,737	(3,622)	-31.89%
Malta	0	32	32	n.a.
Panama	2,884	434	(2,449)	-84.94%
U.S. Subtotal	17,094	12,318	(4,776)	-27.94%
U.S. share of world market	13.56%	7.86%	-5.70%	-42.05%

Source: Lloyd's Registry of Shipping, 1986,1991, and MARAD Foreign Flag Merchant Ships Owned by U.S. Parent Companies, July 1, 1986 and July 1, 1991. Price Waterhouse calculations.

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June 10, 1993

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue
Measures, Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington DC 20515

Re: Subcommittee hearings on proposal to reinstate pre-1987 provisions that allowed deferral of shipping income of U.S.-owned foreign shipping companies that is reinvested in shipping operations.

Dear Mr. Chairman:

In connection with your subcommittee's upcoming hearings on the above-mentioned matter, we respectfully ask that the following findings be submitted for the record and be considered in your deliberations.

We have examined the revenue impact on the U.S. Treasury of repealing Subpart F for foreign-based shipping income, taking into consideration the economic impact of such a repeal. These findings can be summarized as follows:

1. The U.S. Treasury originally estimated that inclusion of foreign shipping income in Subpart F would raise $40 million per year on a static, ex ante basis. However, because of the shrinkage of this part of the shipping industry since that date, the current figure would be no more than $20 million per year. Indeed, the GAO estimated that there might not have been any revenue gain at all. This ex ante revenue loss stemming from repeal of Subpart F for foreign-based shipping income would be far more than offset by the following factors:

2. An increase in the number of U.S.-owned foreign flag ships, and hence an increase in corporate profits, would raise about $15 million per year.

3. Creation of as many as 8,000 jobs would raise $60 million in Federal personal income tax and social security tax revenues. If one also considers the multiplier effects from increased employment and economic activity, this figure would rise to about $120 million. State and local tax revenues would be raised by approximately $30 million due to the original impact, with a total gain of $60 million including the multiplier effects.

4. By the end of the decade, increased tax revenues stemming from related economic activity generated by U.S.-owned foreign flag shipping operations would raise as much as $60 million per year.

Thus the proposed changes in the tax laws would boost net Treasury revenue by as much as $195 million per year, compared to only a $20 million ex ante revenue loss from the repeal of Subpart F for foreign-based shipping income, for a net gain of $175 million per year.

With respect to the first point, in a 1990 study, the U.S. government itself conceded that subjecting foreign-based shipping income to taxation probably had not raised any revenues.

When the Tax Reform Act of 1986 subjected shipping income to the Subpart F restrictions, the Treasury estimated that it would raise approximately $40 million per year in additional revenue. Yet in 1990, a GAO study entitled Uncertain Impact of Repealing the Deferral for Reinvested Shipping Income concluded that revenues might not have risen at all, although that was probably due to a reduction in shipping income and revenue generally. Their conclusion (p. 26) stated that "while the exposure to taxation has increased, changes in the corporate tax rate and in income levels may have prevented tax revenues from rising."

That is precisely the point of this study. We have no quarrel with the finding that on an ex ante basis, higher tax rates would lead to higher tax receipts, assuming no changes in shipping revenues or net income. However, it makes little or no sense to assume that is what would happen. For U.S.-owned foreign flag ships have the option of simply shifting ownership so that 51% or more of the company is foreign owned, in which case no income taxes are due. It simply is not possible to maintain a U.S.-owned fleet in the long run when U.S. firms are subject to income taxes and foreign firms are not. That is presumably the underlying economic reason why the GAO study found that tax receipts had not risen.

However, the GAO study confined itself to an examination of a static analysis based on IRS documents. The results of this study, on the other hand, provide a dynamic explanation of the revenue loss, and also indicate how much revenues might increase if the Subpart F repeal were granted. It also takes into account the dynamic impacts of revenues based on an increase in employment, production, and corporate profits.

From 1980 through 1985, the number of U.S.-owned foreign flag ships declined at an average rate of 4.5% per year. From 1986 through 1989, the number declined at an average rate of 9.3% per year. While GAO calls this latter decline "in line" with previous experience, we think the difference is significant. Thus we find an incremental 20% decline in the number of ships over this four-year period due to changes in the tax laws. While no precise figures are available, it is believed that many of these ships became foreign-owned, with the attendant loss of net income and tax revenues to the U.S. Treasury. That probably represents a loss of about $50 million per year in corporate income, or about $15 million in lost corporate income tax revenues.

Furthermore, it is likely that the number of U.S.-owned foreign flag ships would actually increase under Subpart F repeal for several reasons. First and most obvious, the flight to foreign ownership would stop. Second, firms with ownership interests in both U.S. and foreign-owned companies would be more likely to add new ships in their U.S.-owned companies. Third, some firms that had previously switched to foreign ownership to avoid taxes could move back to U.S. ownership.

It is also likely that employment in water transportation, including ancillary services, would also increase. Employment in waterborne trade (SIC 44) has been declining for many years, with a trend reduction of about 2,000 per year; this figure was temporarily reversed in 1991 and 1992 because of the increased movement of goods associated with Operation Desert Storm. However, when shipping income became subject to the Subpart F regulation in 1986, employment declined to 10,000 that year; this was not just a one-year fluke, since employment failed to rebound in the subsequent four years. That suggests a loss of as many as 8,000 U.S. jobs due to the change in the tax laws, most of these in ancillary marine transportation services. If the average annual wage for these jobs is about $30,000 per year, then restoration of the jobs would represent a total of $240 million in additional wages each year.

Of that amount, approximately 10% would be paid in Federal income taxes, and another 15% in employer and employee contributions for social security and related taxes. That would indicate a net gain to the Treasury of approximately $60 million per year. In addition, state and local government revenues would increase by approximately $30 million per year, some of which might result in smaller grants-in-aid from the Federal government. Such calculations could be very important for key coastal states.

It is also likely that the increase in employment would create further gains in the economy through multiplier effects, as this additional income is spent on domestically produced goods and services. Using the standard multiplier estimate of 2, the revenues from increased economic activity would rise to $120 million per year.

Total shipping revenues from exports and imports totalled $18.8 billion in 1992. It is estimated that U.S.-owned foreign flag ships accounted for approximately 10% of that revenue, or slightly less than $2 billion. Without any change in existing tax legislation, that figure is likely below $1 billion over the next decade. On the other hand, if foreign flag shipping income were to be exempted from Subpart F taxation, the figure could rise to as much as $3 billion, indicating an incremental gain of as much as $200 million per year in shipping receipts.

Using a conservative estimate, it is likely that at least 5% of that incremental increase in receipts would be used to buy U.S.-produced goods and services, such as Diesel engines, navigational aids, and shipyard repairs, resulting in a $10 million annual gain in such purchases. That figure would then expand to as much as $100 million per year by the end of the next decade.

Finally, using the figures quoted above in which 30% of the incremental revenue returns to the Treasury, and a multiplier of 2, that would raise as much as $60 million per year for the U.S. Treasury and $30 million per year for state and local governments,a decade from now.

Sincerely yours,

Michael K. Evans

Michael K. Evans
Evans Economics, Inc.

cc: The Honorable Sam M. Gibbons
The Honorable E. Clay Shaw

CARIBBEAN
LATIN AMERICAN ACTION

June 25, 1993

The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue Measures
House Committee on Ways and Means
1105 Longworth House Office Building
Washington, DC 20515

RE: Subcommittee Press Release #6
June 24 Hearing; Foreign Tax Proposals

Dear Mr. Chairman:

I am submitting this statement on behalf of the Board of Trustees of Caribbean/Latin American Action (C/LAA) and its Chairman, Mr. J. Paul Sticht (Chairman, RJR Nabisco, (ret.)). C/LAA supports **the reinstatement of pre-1987 tax provisions that allowed deferral of shipping income of Controlled Foreign Corporations (CFCs) that is reinvested in shipping operations.** Proposals have been made by Congressman Jefferson and Congressman Shaw in this regard, and your Subcommittee heard from witnesses on this foreign tax matter on June 24.

C/LAA is a non-profit organization qualifying under 501 (c)(3) of the Internal Revenue Code. Our overriding goal is to promote private-sector generated economic development--in the countries of the Caribbean Basin, in Mexico, and in Venezuela and Colombia. We pursue this goal by (a) stimulating trade and investment in these countries; (b) participating in the founding of self-sustaining private sector institutions dedicated to nation building; and (c) advocating the adoption of liberal trade and investment policies by and among these countries and by the United States.

Reinstatement of the pre-1987 tax provision is viewed by C/LAA as of profound importance to the continued expansion of trade and investment with the Caribbean Basin, Mexico, Colombia, and Venezuela.

As a nation which must now vigorously compete for world commerce, we cannot afford to see the demise of U.S.-controlled shipping. We believe that there is a critical synergy between U.S.-owned common carriers, and U.S. firms involved in international trade and commerce. Evidence exists of a correlation between the U.S. carriers' share of cargo in particular trades, and U.S. export performance.

This is apparent in the Caribbean Basin and Latin American trades. U.S.-controlled shipping is carrying the majority of containerized traffic to and from these regions. Over the past five years, U.S. exports to these areas grew by 11 percent annually--and manufactured exports grew by more than 20 percent each year. By comparison, U.S. exports worldwide grew less than 7 percent annually over the same period, and U.S.-owned carriers handled only about 25 percent of this worldwide traffic.

We are fortunate to have several U.S.-controlled carriers serving the Caribbean Basin and our export performance as a nation is greatly benefitting from that service. These carriers make it possible for U.S. firms to meet the delivery time and quality requirements of their foreign buyers. For example, when Caribbean and Central American nations began to increase their participation in the assembly and export of apparel, U.S.-controlled carriers responded with specialized containerized services to facilitate movement of the U.S. component fabrics used in these garments. Today, the great majority of Caribbean Basin apparel exports are made with U.S. fabrics and other U.S.-made components.

Domestically-controlled carriers are this nation's best export promotion institution. C/LAA consistently includes these carriers in our trade missions to the Caribbean Basin, Mexico, Venezuela, and Colombia. Our U.S carriers are international matchmakers, finding new export opportunities for competitive U.S. industries. Their efforts are expanding job opportunities in the United States that could easily have gone abroad.

U.S.-controlled carriers are also providing extraordinary assistance in overcoming the primitive port infrastructures found in the Caribbean Basin and to surmount other logistical barriers to the efficient and rapid movement of cargo to Latin American destinations. They have been praised for their support of U.S. drug interdiction efforts, despite the high cost of these measures in commercial terms. The Agency for International Development has repeatedly commended the U.S. carriers for their cooperation in the development of the smaller Caribbean islands, which suffer some of the most difficult transportation problems.

The C/LAA Transportation Task Force has been one of our most active groups in supporting the Caribbean Basin Initiative and related trade initiatives. On June 24, a original corporate member of that Task Force, Birdsall, Inc. of Riviera Beach, Florida[1] testified before the Subcommittee on Trade of the Committee on Ways and Means, in support of the "Caribbean Basin Free Trade Agreements Act," (H.R. 1403) legislation which you are co-sponsoring. The witness for Birdsall, Inc. stated the following:

> "With the help of H.R. 1403, U.S.-Caribbean trade will continue to expand--and more trade translates into demand for newer, more cost-efficient ships.... Since 1986, the U.S. has imposed an immediate tax on U.S. owners for shipping income earned by controlled foreign corporations. This regime is the most onerous of any major maritime nation and has significantly disadvantaged the U.S.-owned international flag fleet serving the Caribbean Basin."
>
> "Unless corrected, Birdsall and other U.S. owners serving the Caribbean will be forced to sell their operations to foreign interests that are relieved of taxes on their capital investments in shipping."
>
> "The U.S.-controlled fleet serving the Caribbean Basin has helped to establish critical commercial ties between U.S. exporters and the Region's business sector. If foreign-owned carriers are the only ones serving this Region, the attention and effort dedicated to building U.S.-Caribbean ties is surely going to decrease."
>
> "Mr. Chairman, Congressman Jefferson and Congressman Shaw have a made a proposal to reinstate the U.S. tax policy that was in effect before 1986, under which U.S. owners of foreign shipping operations could defer taxes on income reinvested in shipping assets. Their proposal would substantially improve our ability to augment our service to the Caribbean Basin, and to foster more two-way trade, more U.S. exports, and healthier Caribbean Basin economies."
>
> "So we hope that both H.R. 1403, and the Jefferson/Shaw proposals will win the support of the full Committee and Congress."

In response to this part of the Birdsall, Inc. testimony, Chairman Gibbons stated that he was supporting reinstatement of the pre-1987 policy on deferral of shipping income.

C/LAA believes that our strategic interest in the economic health of the Caribbean Basin requires coordinated tax and trade policies. We have liberalized our trade regime to grow the export sectors of the Caribbean Basin economies, and we are seeking further extension of these policies (H.R. 1403) to respond to the effects of the North American Free Trade Agreement.

We must also make certain that we will have U.S.-owned carriers participating fully in that trade expansion. Otherwise, our positive trade balance with the region is put in serious jeopardy. Accordingly, C/LAA urges immediate and unconditioned reinstatement of the reinvestment rule for shipping income of CFCs.

Best Regards,

Peter Johnson
Executive Director

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[1] Birdsall, Inc. owns 100 percent of the stock of Tropical Shipping and Construction Co., Ltd., a Bahamian shipping corporation.

STATEMENT OF GARY J. PERKINSON
BENEFICIAL CORP

Mr. Chairman and Members of the Subcommittee on Select Revenue Measures, Beneficial Corporation is pleased to submit to the Subcommittee its testimony in response to the Subcommittee's invitation to comment on a proposal to expand the categories of Canadian and Mexican subsidiaries of U.S. corporations that may be treated as domestic corporations for U.S. tax purposes. Under current law, U.S. parent corporations can elect to treat their Canadian and Mexican subsidiaries as U.S. corporations under certain conditions. As a corporation engaged in multinational business operations, we are aware of instances in which these current rules are so unclear that U.S. corporations can not safely determine whether their Canadian and Mexican subsidiaries qualify for this election. This proposal, if enacted, would greatly simplify the application of the U.S. tax laws in this area and promote certainty for both taxpayers and the IRS.

Current Law

Under current law, a U.S. corporation owning or controlling, directly or indirectly, all of the outstanding stock of a corporation formed in a contiguous foreign country (i.e., Canada or Mexico) may elect under section 1504(d) of the Internal Revenue Code to treat that corporation as a domestic corporation for U.S. tax purposes, but only if that contiguous country corporation is "maintained solely for the purpose of complying with the local laws of such country as to title and operation of property." If such an election is made by the U.S. parent of a consolidated group of corporations for one of its Canadian or Mexican subsidiaries, that subsidiary's income and other tax attributes are taken into account currently in the U.S. consolidated return. Thus, for U.S. tax purposes these subsidiaries are essentially treated no differently than the parent's U.S. subsidiaries. While the election subjects all of the subsidiary's income to current taxation, there are often tax benefits, such as simplified tax accounting and reporting and improvements of the U.S. parent's foreign tax credit position, that result from the election.

Canadian and Mexican laws often require foreign (e.g., U.S.) businesses conducting business within those countries to incorporate locally as a prerequisite to conducting those business operations. In many cases, while no Canadian or Mexican law expressly requires incorporation, the ability of foreign companies to conduct a particular business, or to obtain required licenses or regulatory approval, is conditioned as a matter of administrative practice on their incorporating under that foreign country's laws. In these latter cases, whether a contiguous country corporation is maintained solely for the purpose of complying with the local laws of Canada or Mexico as to title and operation of property, as required by section 1504(d), is often a very difficult determination to make.

A contiguous country corporation may meet the requirements for the section 1504(d) election where, even though no statutory law expressly requires its incorporation, incorporation is required under administrative practice or policy. A recent decision of the U.S. Court of Appeals for the Sixth Circuit, U.S. Padding Corp. v. Commissioner, 865 F.2d 750 (6th Cir. 1989), affirmed this interpretation of section 1504(d). Much uncertainty continues to exist, however, over whether an administrative practice or policy of a particular country requires incorporation. This uncertainty makes it difficult for U.S. corporations to determine whether their subsidiaries qualify for the election.

In addition, some criticism of existing law has been directed at the ability of taxpayers to selectively choose which subsidiaries will elect and for how long, in effect "cherry-picking" the results.

Legislative Proposal

The proposal would modify the section 1504(d) election to make the election available to all Canadian and Mexican corporations that would be members of the U.S. parent's affiliated group were it not for the fact that they are foreign corporations, without regard to whether those corporations are maintained solely for the purpose of complying with foreign laws. To prevent potential abuses that exist under current law, a consistency rule would require that the election be made for all Canadian and Mexican corporations that would be members of an affiliated group. Thus, U.S. corporations would not be permitted to "cherry-pick" the Canadian and Mexican subsidiaries for which the election would be made, but rather would be required to make the election on an "all or none" basis. In addition, revocation of the election would only be permitted with the approval of the Commissioner of IRS.

Comments on Proposal

We strongly encourage the enactment of this balanced proposal to provide U.S. corporations greater certainty as to whether their Canadian and Mexican subsidiaries qualify for the election. It will permit corporations that are currently uncertain as to how the IRS will interpret section 1504(d) (i.e., in cases where the legal requirement of incorporation is less than clear) to make the election free from the concern that the IRS will challenge the validity of their elections. At the same time, it will limit the adverse selection character of current law through a new "all or none" requirement. Thus, both the IRS and taxpayers stand to benefit.

In addition to adding greater certainty, the enactment of this proposal would simplify the U.S. tax treatment of these subsidiaries for both taxpayers and the IRS. For example, Canadian and Mexican subsidiaries of U.S. corporations to which this election applied would no longer be required to deal with the complexities of the various anti-deferral regimes of the Code and monitoring the intricate deemed-paid credit rules of sections 902 and 960. Moreover, for corporations for which the election was made, section 482 transfer pricing issues would be greatly reduced because all of their income would be subject to current U.S. tax. This would reduce the amount of taxpayer and IRS resources that are currently devoted to these issues.

Finally, the proposal would further a tax policy objective underlying many of the Congressional reforms in the international tax area in recent years: it would eliminate the differences in U.S. tax treatment between foreign branches and electing foreign subsidiaries of U.S. corporations.

While we are unaware of any formal revenue estimate for this proposal, we believe that the revenue impact from its enactment should be minimal or even positive. This is so because the subsidiaries' income will be taxed currently in the U.S., and contrary to present law the election, if made, will apply (until revoked with the consent of the Commissioner) to all Canadian and Mexican subsidiaries owned by a particular consolidated group. This will include those with respect to which the election would be adverse to the taxpayer as well as those with respect to which it would be helpful.

We appreciate the opportunity to make this submission to the Subcommittee. We are available to respond to any inquiries of the Subcommittee or the staffs of the Ways and Means Committee and Joint Committee on Taxation regarding this proposal.

STATEMENT OF GENERAL MOTORS CORPORATION
PRESENTED TO THE
HOUSE WAYS AND MEANS SUBCOMMITTEE
ON SELECT REVENUE MEASURES
JULY 13, 1993

Mr. Chairman, and Members of the Subcommittee:

General Motors Corporation is grateful for the opportunity to comment on two of the miscellaneous tax proposals that were the subject of recent hearings held by the Subcommittee on Select Revenue Measures of the House Ways and Means Committee. As noted more fully below, General Motors believes the rules for allocating interest expense should be modified and supports the proposal to modify the rules for allocating interest expense of certain financial service providers as long as it does not discriminate against financial institutions that predominantly do business with retail purchasers of products manufactured by related parties. GM also supports the proposal to extend the carryover period for foreign tax credits.

General Motors believes it is critically important for U.S. multinationals to be internationally competitive in order to succeed in the rapidly developing global economy. In this regard, it is imperative that U.S. tax laws not unfairly hinder or penalize international activity of U.S. multinationals. Unfortunately, actions by the U.S. government in recent years to close "loopholes" or correct perceived abuses by a few taxpayers have led to the enactment of many foreign tax provisions which have dramatically increased the administrative burdens on U.S. multinationals and resulted in double taxation of their foreign earnings.

Interest Allocation Rules For Financial Service Providers

Prior to the 1986 Tax Act, applicable law and regulations treated interest expense as fungible, but interest expense of an affiliated group was apportioned separately for each company based on the relative amount of income from U.S. and foreign sources. Congress became concerned, however, that under prior law taxpayers could limit artificially the interest expense attributable to foreign sources by arranging borrowings so that the interest expense would be incurred by a member of the group with primarily U.S. source income. As a result, Congress mandated in the 1986 Act that interest expense of an affiliated group be allocated and apportioned on a consolidated basis, based on the ratio of domestic to foreign assets of the consolidated group. The underlying premise was fungibility, i.e., that all assets within the group are funded by equal portions of the total debt and equity of the group.

At the time of the 1986 Act, Congress recognized that highly leveraged active financing businesses should be treated differently from less leveraged manufacturing businesses. This was in part based on the recognition that for financing businesses to be competitive, they must finance their assets with a higher percentage of debt to equity since debt capital is generally less costly than equity capital. Conversely, manufacturing businesses must finance a greater portion of their assets with equity capital because a much greater portion is invested in fixed (non-liquid) assets with longer term business risks. Unfortunately, for administrative reasons, Congress limited the separate group treatment for active financing businesses to only commercial and savings banks that are required by federal or state regulation to operate separately from their nonfinancial affiliates. General Motors believes that the separate group treatment should equally apply to similarly situated finance companies competing with each other to finance consumer purchases.

For General Motors, the 1986 interest expense apportionment rules cause a portion of the interest expense incurred by its highly leveraged active financing subsidiary, General Motors Acceptance Corporation ("GMAC"), to be allocated to General Motors' foreign source income from its lower leveraged manufacturing activities. This has led to double taxation of General Motors' foreign earnings from its overseas manufacturing operations.

General Motors is concerned about being placed at an unfair competitive disadvantage by these rules with respect to both its foreign investments as well as GMAC's U.S. operations. Foreign investments by General Motors attract excessive U.S. interest expense allocations resulting in double taxation of the earnings from those investments which its competitors do not incur. Similarly, GMAC's U.S. operations are at a competitive disadvantage in expanding its U.S. business because a portion of GMAC's additional interest expense will be allocated to General Motors' foreign source general limitation income, resulting in double taxation that effectively increases GMAC's after tax cost of funds.

It is noted that current U.S. tax rules recognize the difference in leveraging inherent in financing and manufacturing businesses with respect to allocating interest expense for foreign corporations doing business in the U.S. (our competitors!). In particular, in Treas. Reg. Sec. 1.882-5(b), foreign corporations engaged in a U.S. banking, financing or similar business are allowed to assume ninety-five percent of their assets are financed by debt and can allocate interest expense to their U.S. business based on that assumption. For this purpose, financing businesses are not limited to commercial and savings banks but rather include all foreign corporations engaged in any active financing business. The fungibility concept should not be applied differently to the advantage of foreign finance businesses doing business in the U.S. versus U.S. multinationals trying to compete abroad.

Also, the separate foreign tax credit basketing rules for active financing and manufacturing businesses further illustrate the appropriateness of separately allocating the interest expense of each of these businesses. As a part of the 1986 Tax Act, Congress mandated that the foreign tax credit must be separately applied to foreign source income derived from active financing businesses ("financial services basket") and from manufacturing businesses ("general limitation basket"). As a result of this mandate, foreign taxes paid on income arising from GMAC's active financing business cannot be used to offset U.S. tax on GM's manufacturing business even if the businesses are conducted in the same foreign country. When GMAC operates in a foreign jurisdiction as a branch, the interest expense of the foreign branch reduces the foreign taxes paid by the branch. This, in turn, reduces the creditable foreign taxes in the financial services basket. The U.S. interest expense allocation rules require that a portion of this interest expense which reduced the creditable foreign taxes of GMAC in the financial services basket be allocated to GM's foreign source income in the general limitation basket. This cross basket allocation of interest expense leads to perverse results.

In summary, the differences in leveraging inherent in financing and non-financing businesses should be taken into account for all manufacturing businesses which separately operate financing businesses by allocating interest expense separately for those businesses.

Extension of Foreign Tax Credit Carryover Period.

The current carryover period for foreign tax credits is two years back and five years forward. The carryover period for net operating losses is three years back and fifteen years forward. General Motors supports the proposal to change the carryforward period for foreign tax credits from the current five year period to fifteen years so that it is the same as the net operating loss carryforward period. This change is eminently reasonable since taxpayers cannot utilize their foreign tax credits during periods of net operating losses. The subcommittee should also change the carryback period to three years for the same reason.

Conclusion

Once again, General Motors appreciates the opportunity to express our views on the miscellaneous tax proposals being considered by your subcommittee.

ALLOCATION AND APPORTIONMENT OF DEDUCTION FOR STATE INCOME TAXES

Written Statement
of
Chevron Corporation
for the
House Ways and Means Subcommittee on Select Revenue Measures
Hearings on
Miscellaneous Revenue Issues
June 24, 1993

The final regulations concerning the allocation and apportionment of the deduction for state income and franchise taxes, published by the Internal Revenue Service on March 12, 1991, hamper the ability of U.S. taxpayers to compete internationally. Those regulations require that State and local income taxes be allocated to, and apportioned between, income from U.S. and foreign sources. This allocation requirement restricts U.S. multinationals efforts to compete with their foreign counterparts. Allowing the deduction for State income taxes to be allocated entirely to U.S. source income would remedy this inequity.

The anticompetitive aspects of the treatment of the regulatory deduction for state income taxes can be seen in three general areas: taxpayers have been burdened by changing and retroactive IRS positions and requirements, the regulations discriminate against U.S. multinational companies, and the regulations result in an unequal burden among similarly situated U.S. companies.

- Taxpayers have been burdened by changing and retroactive IRS positions.

The IRS regulations requiring U.S. multinationals to allocate a portion of their deduction for state income taxes to foreign source income were issued after several major changes in the IRS position. IRS regulations requiring some apportionment of the state income tax deduction to foreign income were first issued in 1977. Then a 1979 revenue ruling interpreting those regulations held that a franchise tax measured by income should not be allocated to foreign source income because it was a cost of doing business in the state. However, in 1987 this ruling was reversed, retroactively, for U.S. corporations and prospectively for foreign corporations. Then, in December of 1988, the IRS issued proposed regulations retroactive to 1977, which required an even more extensive apportionment of state income tax to foreign source income. Despite substantial criticism, these retroactive regulations were finalized without substantive changes on March 12, 1991. 56 Federal Register 10, 365 (March 12, 1991).

Not only has the IRS shifted its position on this issue a number of times, but it has also added enormously to the requirements for making the apportionment in each succeeding revision of its position. Moreover, the current IRS position is particularly offensive because the change it proposed for the first time in 1988 is applied retroactively all the way back to 1977.

- The IRS regulations discriminate against U.S. multinational companies.

The IRS regulations adversely impact the competitiveness of U.S. multinationals in world markets. Under the regulations, U.S. corporations with overseas operations must generally make some apportionment of their state tax deduction to foreign source income. For those multinational companies with excess foreign tax credits as calculated under the tax code, the additional foreign source deductions from the apportionment of some state tax to foreign income will not provide any useful benefits. The U.S. companies in this situation are, in effect, denied the ability to fully deduct their state income taxes. However, foreign multinational companies operating with U.S. subsidiaries can generally deduct all of their state income taxes from U.S. source income. These foreign competitors, then, obtain the full benefit of their deduction for state income taxes while the U.S. multinationals are saddled with an additional cost of doing business.

The IRS has based its position on the premise that some states are taxing foreign source income through their tax systems, particularly the states that use the worldwide combined unitary method of taxation. States have understandably taken issue with this position since they are constitutionally prohibited from taxing income attributable to activities outside their borders. States believe, as do we, that as long as their taxing systems pass constitutional muster, the tax they levy is based on activities within that state, and as such should be entirely a U.S. source deduction.

The United States has witnessed a gradual erosion of its world economic power over the last several decades. Concern by America's leaders over this erosion has been growing, as evidenced by the extensive hearings the House Ways and Means Committee has held on the important subject of international competitiveness. If U.S. companies are to have any chance of remaining competitive in the global marketplace, the country's policymakers must work to minimize the anticompetitive impacts of America's own policies.

- The regulations result in an unequal burden among similarly situated taxpayers.

The regulations will apply differently to U.S. companies, depending on where they do business. The reasons for these discriminatory results are basically irrelevant circumstances, such as in which states a taxpayer has substantial operations. Taxpayers with headquarters or substantial operations in combined unitary states will experience higher costs of operations because they will be required to apportion a substantial amount of state tax to foreign source income. On the other hand, taxpayers with headquarters in noncombined states and with operations in combined unitary states incur a smaller cost of operating in combined unitary states since their factors are substantially less than those of companies with headquarters and substantial operations in combined unitary states. Such geographically arbitrary results cannot be justified on any tax policy basis.

Historically, the states have had wide latitude in determining their individual tax regimes. The federal government has not tried to limit their discretion, and the courts have generally upheld the states. Not all states have income taxes, and only a few continue to use the combined unitary method. Given this latitude which the states have been allowed in determining the value of in-state activities, there is no rational basis to conclude that state taxes must be allocated to foreign source income in some states, but not in others.

Retroactive application of the regulations exacerbates this unequal impact on taxpayers by discriminating among taxpayers, depending on whether they have open years after the effective date. Some taxpayers who have allocated all state taxes to U.S. source income may have closed years after the regulations' effective date and are not required to change their filings. Other taxpayers, whose same tax years are still open, will be required to make the proposed allocation and apportionment. U.S. companies subject to this retroactive application will be burdened with yet another incremental cost of doing business not imposed on their competitors, making it even more difficult for them to compete both domestically and abroad.

Conclusion

The current IRS policy requiring a substantial apportionment to foreign source income of the deduction for state income and income-based franchise tax restricts the ability of U.S. multinationals to compete internationally. U.S. companies are subject to changing requirements and additional costs of doing business not borne by foreign companies and not even uniform among U.S. companies. At a time when the U.S. is struggling to maintain its economic position in the world, the federal government should concentrate on adopting policies promoting, or at least not hindering, the ability of U.S. companies to compete internationally. Treating all deductions for state income tax as U.S. source deductions is one such policy and has been supported in the past by the National Governors' Association, the state tax administrators, and numerous business organizations representing a broad range of multinational business interests. Adopting legislation implementing this policy is one clear step Congress can take to remove an anticompetitive policy of the federal overnment.

STATEMENT OF ROBERT C. ROZYCKI
ON BEHALF OF
FEDERAL-MOGUL CORPORATION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURERS
OF THE
HOUSE WAYS AND MEANS COMMITTEE
CONCERNING
FOREIGN TAX PROVISIONS

JULY 13, 1993

INTRODUCTION

As the Director of Taxes for Federal-Mogul Corporation, I Robert C. Rozycki thank the committee for this opportunity to present the company's views concerning Foreign Tax Provisions.

Federal-Mogul, a Fortune 300 Company with approximately $1.3 billion in annual sales, globally distributes and manufacturers a broad range of precision parts primarily for automobiles, trucks and farm and construction vehicles. Since Federal-Mogul conducts business in over 45 countries throughout the world, fair and equitable tax policy by the U.S. with respect to foreign tax provisions is critical. Two items are of particular concern to Federal-Mogul's ability to do business internationally on a competitive basis. Accordingly, the company submits the following statements with respect to the (i) extension of the carryforward period for excess foreign tax credits and a related issue of (ii) the recapture of domestic source losses.

EXTENSION OF THE CARRYFORWARD PERIOD FOR EXCESS FOREIGN TAX CREDITS

Current Law. Section 904(c) of the Code permits a taxpayer to carry excess foreign tax credits back two years and forward five years. The present seven-year carryback and carryforward period for excess foreign tax credits was enacted so that the foreign tax credit mechanism could fulfill its dual purpose of (i) avoiding double taxation of foreign source income of U.S. taxpayers and (ii) permitting the economic matching of expenses and income by U.S. taxpayers.

Tax credits not utilized by a taxpayer during this seven-year period commonly expire because expense allocation rules have severely reduced or eliminated a taxpayer's foreign source income. When this happens, taxpayers are subject to double taxation, which discourages overseas investment by U.S. companies and permits foreigners to capture overseas markets.

Proposed Change. The current five-year carryforward is simply inadequate to accomplish the purpose of the foreign tax credit mechanism of eliminating double taxation. H.R. 5270 "Foreign Income Tax Rationalization and Simplification Act of 1992" ("H.R. 5270") previously proposed that the foreign tax carryover period be expanded to permit a taxpayer to carry excess tax credits back three years and forward fifteen years.[1] The proposal to expand the carryforward period to fifteen years contained in the miscellaneous tax proposals should be enacted.

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[1] H.R. 5270, section 113.

Discussion. Many of the developed countries do not tax income earned outside their borders. Unlike those countries, the U.S. subjects its citizens, resident aliens, domestic corporations, domestic partnerships, and domestic trusts and estates to income tax on the basis of their worldwide income, regardless of source. As a matter of tax policy, as well as treaty obligations, the U.S. generally eliminates double taxation by granting a credit against a taxpayer's U.S. tax liability for foreign taxes paid (or deemed paid) or accrued with respect to their foreign source income. In this way, the U.S. exercises primary taxing authority and taxes all U.S. source income. Furthermore, it effectively limits U.S. taxation of foreign source income to only that income which is taxed at a rate less than the U.S. rate.

The section 904(c) foreign tax credit carryforward period was enacted as part of the Technical Amendments Act of 1958 to effectuate the U.S. tax policy of avoiding double taxation of foreign source income and ameliorating distortions caused by timing differences in income and expense recognition between foreign and U.S. tax accounting rules.[2]

Until changes were made to the U.S. foreign tax system as part of the Tax Reform Act of 1986 ("TRA 1986"), the carryover period of section 904(c) largely proved adequate to fulfill its purpose. As a result of TRA 1986, however, the allocation rules for interest expense (as well as other expense items) dramatically reduced the net foreign source taxable income that could be used to credit foreign taxes. The major problem is the limited, one-way "fungibility" concept. This has resulted in interest expense incurred by a U.S. taxpayer being allocated to U.S. and foreign source income based on the assets held by the taxpayer, rather than based on the income earned by the taxpayer.[3]

As a result, for U.S. multinational taxpayers, significant amounts of interest expense are allocated to separate limitation categories of foreign source income without regard to (i) the interest burden already supported by the foreign members of the groups, (ii) the foreign source income derived by the U.S. multinational taxpayers, or (iii) the ability of foreign members to deduct the allocated U.S. expenses against their taxable incomes in foreign jurisdictions. Thus, subsequent to 1986, U.S. multinational taxpayers generated significant excess foreign tax credits in their separate limitation categories of foreign source income. This result has been more pronounced for (i) capital intensive taxpayers in mature industries in the United States that recently expanded their operations overseas but had yet to generate significant cashflows from such investments and (ii) taxpayers experiencing low profits from their overseas activities as a result of the slow-down in the world economies.

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[2] See H.R. Rep. No. 775, 85th Cong., 1st Sess. (1957), 1958-3 C.B. 811, 837-38 and 892-94 ("1957 House Report"); S. Rep. No. 1983, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 922, 1038-39 ("1958 Senate Report"); H.R. Conf. Rep. No. 2632, 85th Cong., 2d Sess. (1958), 1958-3 C.B. 1188, 1192 ("1958 Conference Report"). As part of the matching concept, Congress recognized that the carryover period would also permit taxpayers to average foreign taxes against the foreign income derived over the relevant carryover period. 1958 Senate Report, 1958-3 C.B. at 1039; 1958 Conference Report, 1958-3 C.B. at 1192. See also the individual views of Senator Paul H. Douglas contained in Part VI of the 1958 Senate Report, 1958-3 C.B. at 1184.

[3] In addition to the 1986 interest expense allocation rules, utilization of excess foreign tax credits is hampered by the overall foreign loss recapture rules of section 904(f)(1) and the non-recapture of the overall domestic source losses (further discussed below).

The excess foreign tax credits resulting from the TRA 1986 modifications are now beginning to expire unutilized. This frustrates the U.S. policy behind the foreign tax credit tax mechanism as previously discussed. By extending the carryforward period to fifteen years as proposed in H.R. 5270, taxpayers are provided an opportunity to earn their way out of excess foreign tax credit positions, arising from the interest allocation rules, through the generation and repatriation of foreign source income. This will also accomplish the economic matching of income and expenses.[4]

Given the acute excess foreign tax credit positions of many taxpayers, if the carryforward period is not extended, taxpayers can be expected to modify their business behavior to the detriment of the U.S. economy. Even now, the five-year carryforward period inhibits the repatriation of foreign earnings for fear of commencing the "clock" on excess foreign tax credits triggered by a dividend distribution to the U.S. parent.[5]

A more insidious, but natural, response to excess foreign tax credits and the resulting double taxation, will be for U.S. multinational taxpayers to dispose of their foreign operations. It is not uncommon for foreign source income to bear an effective combined U.S. and foreign tax rate well in excess of the U.S. statutory rate, even when operating in a "medium-tax" jurisdiction. If taxpayers have no prospect for utilizing their excess foreign tax credits, it often will be more profitable for them to sell their foreign operations to non-U.S. persons than to continue such operations under the U.S. tax regime. As U.S. multinationals reduce their foreign operations, the balance of payments and trade for the United States will likely be adversely affected.

Given the present United States tax regime applicable to foreign source income, and the necessity to fulfill the objective of the foreign tax credit mechanism, the section 904(c) carryforward period should be extended to fifteen years as previously proposed by section 113 of H.R. 5270.

RECAPTURE OF DOMESTIC SOURCE LOSSES

Current Law. Overall losses from domestic sources reduce foreign source income under section 904(f)(5)(B). However, the Code does not specifically allow the losses to be restored as foreign source income when domestic source taxable income is subsequently earned. This is unlike the recapture rules applicable to overall foreign losses under section 904(f)(1) which restores domestic source income when net foreign source income subsequently is earned. This lack of restoration unfairly prevents taxpayers from being able to use their foreign tax credits orphaned by the permanent reduction of foreign source income. When the foreign tax credits expire unutilized, taxpayers commonly suffer double taxation on their foreign source income.

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[4] Although the extended carryover period may also facilitate the averaging of high-tax foreign source income in a separate limitation category with low-tax foreign source income in such category, the ability to average taxes is a feature of current law that was contemplated and accepted by Congress when section 904(c) was enacted in 1958.

[5] Although the proposed section 956A "excess passive asset" rules applicable to controlled foreign corporations are intended to counteract the inhibition to repatriate, the impact will be limited to only certain controlled foreign corporations.

Proposed Change. As part of H.R. 5270, a resourcing rule was proposed whereby up to 50% of the annual U.S. source taxable income subsequently derived by a taxpayer would be resourced as foreign source income in a separate limitation category to the extent that income in such limitation category previously had been reduced by an overall domestic loss.[6] This is only fair since it was the domestic source loss which previously reduced the foreign source income.

Discussion. Because of the widespread importance of this matter, it is important to clarify the present law applicable to recaptures of overall domestic source losses.[7] As a matter of simple tax equity, the resourcing or recapture rules applicable to an overall domestic source loss should parallel the recapture rules applicable to an overall foreign source loss. This parallel treatment can be accomplished by explicitly permitting resourcing of U.S. source income as foreign source income.

Without such a resourcing rule, a foreign competitor operating in the U.S. gains an unfair competitive advantage in cyclical industries, such as the automotive industry. During a down cycle, a U.S. multinational with domestic losses suffers a permanent tax disadvantage by losing foreign tax credits as a result of lost foreign source income. A foreign competitor, however, not claiming foreign tax credits, is permitted to utilize its losses as a future tax benefit in the form of a net operating loss carryforward.

Under the current U.S. tax regime, in order to compete effectively in the United States against U.S. subsidiaries of foreign multinationals, a U.S. multinational in a cyclical industry must sell off all of its non-U.S. subsidiaries and sacrifice its non-U.S. operations, thereby conceding the non-U.S. market to foreign multinationals. This is clearly not the objective of the U.S. foreign tax credit mechanism.

In accordance with the provision proposed as section 112 of H.R. 5270, we strongly support the adoption of rules that will permit resourcing of up to 50% of U.S. source income as foreign source income, to the extent an overall domestic source loss previously reduced foreign source income.

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[6] H.R. 5270, Section 112.

[7] The legislative history to the Technical Amendments Act of 1958 noted that foreign tax credits attributable to foreign source income reduced by an overall domestic loss could be carried forward under section 904(c) by a taxpayer and used to offset the U.S. tax liability attributable to subsequent U.S. source income. 1958 Senate Report, 1958-3 C.B. at 1039; 1958 Conference Report, 1958-3 C.B. at 1192. The legislative history to the TRA 1986 which enacted section 904(f)(5)(B) is silent as to the applicable rules for U.S. source taxable income derived subsequent to an allocation of an overall domestic source loss to foreign source income. See S. Rep. No. 313, 99th Cong., 2d Sess. 307 and 325 (1986), 1986-3 C.B. Vol. 3 307 and 325; H.R. Cong. Rep. No. 841, 99th Cong., 2d Sess. II-592 (1986), 1986-3 C.B. Vol. 4 592. Similarly, the public pronouncements by the Internal Revenue Service issued with respect to the effect of an overall domestic source loss are silent as to resourcing or recapture of subsequent domestic source taxable income. See Rev. Rul. 82-215, 1982-2 C.B. 153 and Rev.Rul. 81-50, 1981-1 C.B. 410 (modified and superseded by Rev. Rul. 82-215, supra).

HEARINGS ON MISCELLANEOUS REVENUE ISSUES

Subcommittee on Select Revenue Measures
of the
House Committee on Ways and Means

July 1, 1993

Written Statement
Submitted By:

William P. McClure
McClure, Trotter & Mentz, Chtd.

This statement is submitted in connection with the Subcommittee's hearings on miscellaneous revenue issues, announced in the Subcommittee press releases dated June 2 and June 11, 1993. We strongly support two of the miscellaneous foreign provisions under consideration by the Subcommittee in these hearings: the proposal to allocate to U.S.-source income all deductions for taxes paid to State and local governments, and the proposal to extend the period to which unused foreign tax credits may be carried. Both of these provisions will reduce the complexity of international tax rules for U.S. companies operating abroad and will enhance the international competitiveness of such companies vis-a-vis foreign companies. We strongly urge the Subcommittee's adoption of these measures.

Allocation to U.S.-Source Income of Taxes Paid to State and Local Governments

The proposal would require that, for purposes of computing the foreign tax credit limitation, all deductions for State and local income or franchise taxes are allocated to U.S.-source income. The proposal would rectify the inequitable and anti-competitive effects of the current scheme of allocation imposed under Internal Revenue Service regulations issued in 1991.

The current rules require in many cases that U.S.-based multinational companies allocate a portion of their State and local income tax deduction to foreign-source income. The rationale for this approach is to attribute part of the State and local tax to foreign-source income where the income tax base includes income that is characterized as foreign-source for Federal income tax purposes. For taxpayers in an excess foreign tax credit position, this allocation rule effectively results in a denial of a deduction for a portion of the State and local income taxes paid.

The regulations requiring the allocation of a portion of State and local taxes to foreign-source income are a misguided attempt to achieve theoretical purity at the expense of simplicity and competitiveness. It would be much more simple and logical to treat State and local taxes as expenses that are allocable entirely to U.S.-source income. States generally seek to impose income tax based on the activities conducted by the taxpayer within the State. The apportionment formula used in many States, for example, is designed to roughly approximate the amount of income properly attributable to activities in the State. The allocation rules, therefore, should view State and local taxes as expenses properly attributable to activities that generally produce U.S.-source income. It is unfair to effectively deny a deduction for a portion of State and local taxes solely because the States and the Federal government use different methods of measuring the income derived from U.S. and foreign sources.

Not only does the rule in the regulations increase the administrative and compliance burden of U.S.-based companies with overseas operations, this allocation scheme also places U.S.-based multinationals at a competitive disadvantage both as compared to foreign competitors and compared to domestic competitors not engaged in activities abroad. Because the allocation to foreign-source income effectively denies the benefit of a deduction for the full amount of State and local taxes paid for companies in an excess credit position, the allocation rules impose an additional cost of doing business upon such U.S. companies.

Foreign companies operating in the United States through U.S. subsidiaries, however, are generally permitted a full deduction against U.S.-source income for State and local taxes paid. Thus, this allocation rule is another of the many aspects of our foreign tax credit system that impede U.S. companies' ability to compete internationally. The allocation rule in the regulations also produces unequal treatment between U.S. companies that have foreign operations and those that do not. U.S. companies that do not operate abroad and have no foreign-source income do not have to make any artificial allocations with respect to State and local taxes paid. In this situation, all of the taxes paid are fully deductible. Again, the cost of doing business for the U.S.-based multinational is higher.

The proposed legislation would rectify this situation by providing that deductions for State and local taxes are allocable entirely to U.S.-source income. We strongly urge that this proposal be adopted because it would promote simplicity and competitiveness and would recognize the true nature of State and local taxes as viewed from the perspective of the States and localities that levy the taxes.

Extension of the Period to Which Excess Foreign Tax Credits May be Carried

The proposal would permit taxpayers to carry excess foreign tax credits forward 15 years. This proposal would extend the current 5-year carryforward period and would conform the carryover treatment of the foreign tax credit to the treatment afforded net operating losses and general business credits. The proposal would ease the restrictive effect of the unduly short carryover period applicable to the foreign tax credit and thereby reduce the incidence of double taxation on U.S. firms operating abroad. This proposal was included in H.R. 5270, the foreign tax reform bill introduced by Chairman Rostenkowski and Representative Gradison in the 102nd Congress.

Originally, the carryover and carryback periods for the foreign tax credit corresponded to the periods provided for net operating loss carryovers and carrybacks, which were set at a 2-year carryback and a 5-year carryforward. Although the periods have been extended for net operating losses, no relief from the restrictions has been provided for the foreign tax credit.

The intent of the carryover rules for the foreign tax credit is to mitigate the effects of differences between foreign and U.S. tax accounting rules. Often there are substantial differences between foreign and U.S. tax accounting rules that significantly affect a taxpayer's ability to utilize the foreign tax credit. The existence of a carryover period increases a taxpayer's opportunity to credit foreign taxes against the U.S. tax liability attributable to the foreign-source income on which they were imposed. Lengthening the carryover period would ensure that such period is of adequate duration to mitigate the distortive effects of differences between foreign and U.S. rules.

When, due to the truncated carryover period, foreign tax credits expire unused, double taxation is the inevitable result. The potential for double taxation resulting from expiration of the short carryover period is particularly acute because of the numerous limitations and restrictions that further limit the taxpayer's ability to utilize foreign tax credits. Obviously, double taxation has an anticompetitive effect on U.S. businesses operating abroad. Foreign-based competitors generally enjoy the benefit of tax systems in their home countries that minimize or eliminate the possibility of international double taxation.

Accordingly, we strongly urge the Subcommittee's adoption of the proposal to extend the foreign tax credit carryover period to 15 years.

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STATEMENT OF THE COMMITTEE ON STATE TAXATION

Submitted by Mark Cahoon, Executive Director

Hearings on Miscellaneous Revenue Issues

Allocation and Apportionment of the Deductions for State Income Taxes

Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Submitted June 24, 1993

The Committee on State Taxation (COST) appreciates the opportunity to comment on a foreign tax provision currently under review by the Subcommittee as outlined on page 5 (item 12) of the Subcommittee's press release dated June 2, 1993. COST is an organization comprised of about 380 multistate corporate taxpayers. The vast majority of members are U.S. based corporations with international operations. As an organization, COST largely represents the state and local tax function of member companies. Specifically, COST member companies are quite concerned about IRS regulations that require them to treat a significant portion of their deduction for state income and franchise taxes as a foreign expense deduction. A bill (H.R. 1410) to correct this inequity was introduced on March 18, 1993 by Representative Thomas. COST urges the Ways and Means Committee to include in any future legislation a provision to allow a deduction from U.S. source income for all state and local income and franchise taxes.

COST is concerned with barriers to effective competition by U.S. businesses in the world marketplace that result from U.S. tax policy. Some may suggest that the overall structure of income taxation employed by Federal, state and local governments could be revised to make the system more neutral in the international trade arena. Addressing those issues is, of course, a long and difficult process. COST would suggest, however, that adopting the provision on the deduction for state income taxes would improve the ability of U.S. based multinationals to compete more effectively against foreign competitors. This provision would negate IRS regulations requiring U.S. corporations with overseas operations to allocate a portion of their state tax deduction to foreign source income.

For taxpayers with excess foreign tax credits, the effect of current law is that the Federal deduction for state taxes paid is reduced by the amount allocated to foreign source income.

While the regulation is detrimental to all U.S. based multinational corporate taxpayers, its impact varies among taxpayers. The adverse impact of these regulations is greatest upon companies paying substantial taxes to states that base their business taxes on a unitary business theory and so do not clearly exclude foreign-source income from tax. If a multinational company has excess foreign tax credits under their foreign tax credit limitation, the additional foreign source deductions from the allocation of state tax to foreign source income will not provide any useful deduction. U.S. companies in this situation are, in effect, denied the ability to fully deduct their state income taxes. Foreign multinational companies operating with U.S. subsidiaries, however, can generally deduct all of their state income taxes from U.S. source income. These foreign competitors will then obtain the full benefit of their deduction for state income taxes while the U.S. multinationals are burdened with an additional cost of doing business when they are denied the full benefit of their state income tax deduction.

The IRS regulations are based on the theory that some states tax foreign source income. According to the IRS, the part of the state's tax that is attributable to foreign source income should not be deductible against the domestic income of the company, but should be deducted from the income the company produces abroad. This approach results in a doubling of the anti-competitive impact on U.S. companies. First, taxpayers are paying more state tax than they should because the states are taxing foreign income. Second, the taxpayers lose the full benefit of the deduction for state income taxes when they are forced to apportion some of the deduction to foreign source income. For companies with excess foreign tax credits, this means that they get no tax relief, anywhere in the world, for the portion of state tax which must be deducted from foreign income. Purely domestic companies, on the other hand, not only pay less state tax, but also get Federal tax relief for all of the state tax they pay. Similarly, U.S. subsidiaries of foreign parents are generally taxed only on their U.S. income for both Federal and state tax purposes, and are generally allowed a full deduction for their state income tax.

Congress should permit companies to deduct their entire state taxes from the income they earn in the United States. This would eliminate the additional cost of doing business for U.S. multinationals who are adversely impacted by the IRS regulations concerning allocation of state income taxes. This approach has been widely agreed to by both taxpayer groups and organizations representing state governments. Legislation to allocate the deduction for state income taxes entirely to U.S. income has been endorsed in the past by the National Governors' Association, the Western Governors' Association, the Federation of Tax Administrators, the Multistate Tax Commission, the U.S. Chamber of Commerce, the National Association of Manufacturers, the National Foreign Trade Council, the American Electronic Association, the Chemical Manufacturers Association, the Pharmaceutical Manufacturers Association, the Petroleum Equipment Suppliers Association, the American Petroleum Institute and the U. S. Council of International Business. COST urges the adoption of this provision as provided in H.R. 1410.

STATEMENT OF BRUCE H. BARNETT
CARGILL, INC.

Cargill, Incorporated, is pleased to submit this testimony in support of a technical amendment to Section 954 of the Internal Revenue Code. This issue is listed as Item No. 13 under "Foreign Tax Provisions" described on page 5 of the Subcommittee's Press Release No. 4, dated June 2, 1993. The amendment we seek is noncontroversial and is needed to remedy an unintentional problem created when Section 954 was modified as part of the 1986 Tax Reform Act.

Cargill is a 128-year-old U.S. corporation headquartered in Minneapolis, Minn. The company, its subsidiaries and affiliates are involved in more than 40 individual lines of business in over 50 countries around the world. Cargill is perhaps best known as an active trader and processor of agricultural commodities, but the company also merchandises petroleum, manufactures fertilizer, mines salt, and produces steel, among other active business operations.

Under U.S. law, income earned by foreign subsidiaries of U.S. corporations generally is not taxed currently. That income will be taxed when later repatriated to the United States. Subpart F of the Internal Revenue Code denies this deferral treatment under certain circumstances, usually when the taxpayer can manipulate the source of income to take advantage of a host country's lower tax rates.

In 1986, Section 954(c) of the Internal Revenue Code was amended to deny deferral for more income from passive commodities transactions. A new subparagraph (C) was added to paragraph (1) providing that the excess of gains over losses from transactions in commodities was to be included in Subpart F income unless they arose out of bona fide hedging transactions or were "active business gains or losses from the sale of commodities."

As detailed in the legislative history of the provision, the intent of Section 954(c)(1)(C) was to eliminate tax deferral for gains derived from passive, speculative commodities trading. Congress wanted to tax purely passive investors in commodities transactions in a manner similar to other passive investors. However, Section 954(c)(1)(C)(ii) specifically exempted gains and losses derived from the active sale of commodities by substantive and active producers, processors, merchants and handlers of commodities. The legislative history of this section also outlines a stringent set of guidelines for what constitutes the active conduct of a commodities business.

Section 954(c)(1)(C) thus was originally adopted to ensure that substantive and active producers, processors, merchants and handlers of commodities would continue to receive an exemption from Subpart F for active business gains or losses from the sale of commodities. This exception recognizes that not all commodities trading is passive in nature. On the contrary, some commodities trading is an integral part of the active transporting, storing, processing and merchandising of commodities and therefore should continue to receive deferred tax treatment.

At some point in the drafting of the 1986 Tax Reform Act, however, language was inserted in Section 954(c)(1)(C) requiring that "substantially all" of a controlled foreign corporation's business must be as an active producer, processor, merchant or handler of commodities in order for the taxpayer to retain the exemption from Subpart F inclusion for commodities income. This substantially all requirement is imposed in addition to very stringent rules governing the definition of active sales.

The Internal Revenue Service has issued Temporary Regulations, which are now in effect, interpreting the substantially all requirement to mean that at least 85 percent of a taxpayer's taxable income must be in active commodities business activities in order for any of the taxpayer's income from active commodities business to be exempt from Subpart F. The practical effect of the substantially all requirement is that a small amount of noncommodities income -- as low as 15 percent -- can taint otherwise active commodities income and result in its current taxation under Subpart F. For example, if, due to economic conditions in a particular year, a controlled foreign corporation earns 16 percent of its taxable income either from passive investments or from active noncommodities businesses, it would lose deferral on all of its active commodities income.

In fact, even if the taxpayer's other, noncommodities activities qualify independently for exemption from Subpart F, income from those noncommodities activities can work to disqualify the controlled foreign corporation's active commodities income from exemption from Subpart F. For example, a diversified company like Cargill could have a steel plant or other active noncommodities business in a country within the same controlled foreign corporation as its active commodities business. Individually, the steel business and the company's active commodities business in that country would each qualify for exemption from Subpart F. If, however, the steel business in a given year provides more than 15 percent of Cargill's taxable income from that country, then Cargill would lose deferral from current taxation on the entire amount of its commodities income, while income from the steel business properly would retain deferral treatment.

Cargill does not object to the restrictive manner in which Section 954 defines active sales. This definition effectively distinguishes passive, speculative commodities activities from sales arising in connection with an active business. This distinction was the stated objective in enacting Section 954(c)(1)(C) in 1986.

However, the substantially all language currently included in Section 954 should be deleted from the Code. This additional language adds nothing to the process of distinguishing purely passive transactions from active commodities transactions. Strict active sales standards enunciated in the legislative history to the 1986 Tax Reform Act are embodied in the Temporary Regulations and clearly distinguish between the two types of transactions. The addition of the substantially all requirement instead has the unintended effect of penalizing active commodities businesses under certain circumstances.

There is no indication in the legislative history that Congress intended to impose such a penalty on gains from active commodities transactions. In fact, this limitation is inconsistent with other provisions in the Code. For example, Subpart F provides that all of a taxpayer's income will be treated as currently taxable if 70 percent or more of its income is Subpart F income, regardless of the character of the balance. However, Section 954(c)(1)(C) in effect would drastically lower that threshold from 70 percent to a mere 15 percent.

Last year, the Senate Finance Committee adopted a provision in H.R. 11 to remedy this problem by deleting the substantially all requirement from Section 954. That provision was included as Section 8104 of the bill as reported by the Finance Committee. It is our understanding that this provision was dropped in conference, along with a number of other foreign tax provisions, for reasons unrelated to its merits.

At that time, the Joint Tax Committee calculated that the Senate provision deleting the substantially all requirement would have a small revenue effect. However, we believe that eliminating the substantially all requirement would constitute a purely technical correction that does not result in any revenue loss at all. It is clear from the legislative history of Section 954(c)(1)(C) that Congress sought only to distinguish between active commodities processors and merchants and those who are mere passive investors in commodities trade. That distinction has already been achieved under the stringent guidelines adopted by the IRS in its temporary regulations distinguishing active from passive investors. Since Congress did not contemplate the problems created by the substantially all language, there should be zero revenue impact from dropping that language from Section 954(c)(1)(C).

Nevertheless, in the event that Congress believes it necessary to score this provision for revenue purposes, the universe of U.S. companies that potentially could be affected by the substantially all requirement, if it were to be left in place, is extremely small. Moreover, it is likely that in some cases action would be taken to mitigate the impact of the substantially all provision. For example, in some cases taxpayers might isolate their commodities business in a separate corporation to ensure that the 15 percent threshold is not crossed. This latter response is far from desirable, as our foreign competitors in those same markets would not be faced with such a burden. In addition, this response is not always available to corporations operating in foreign countries.

In fact, with respect to Cargill's own operations, Cargill has yet to violate the 15 percent substantially all threshold. However, the active trading and processing of agricultural commodities is a particularly volatile business. It is extremely difficult to predict from year to year just what the income mix might be in a particular market. Therefore, Cargill is seeking to remedy this drafting problem to provide greater predictability and security in the future.

In conclusion, the substantially all requirement poses a real, punitive risk to a taxpayer who is otherwise meeting all other tests as an active producer, processor, merchant or handler of commodities. Cargill strongly urges the adoption of a technical correction, such as the provision adopted in the Senate version of last year's tax bill, to eliminate the substantially all requirement from IRC Section 954(c)(1)(C). A copy of that provision is attached to this statement.

Revenue Act of 1992, H.R. 11, 102d Congress, Sec. 8104,
as reported by Senate Committee on Finance:

SEC. 8104. TREATMENT OF COMMODITY TRANSACTIONS UNDER SUBPART F.

(a) IN GENERAL.—Clause (ii) of section 954(c)(1)(C) (relating to commodity transactions) is amended to read as follows:

> *"(ii) are active business gains or losses from the sale of commodities by the controlled foreign corporation as an active producer, processor, merchant, or handler of commodities, or"*

(b) EFFECTIVE DATE.—The amendment made by subsection (a) shall apply to taxable years of foreign corporations beginning after December 31, 1992.

Technical Explanation of Revenue Act of 1992, H.R. 11, 102d Congress, Sec. 8104, as reported by Senate Committee on Finance:

4. Commodities income of a controlled foreign corporation (sec. 8104 of the bill and sec. 954(c) of the Code)

Present Law

As explained above, when a U.S.-controlled foreign corporation earns so-called "subpart F income," the United States generally taxes the corporation's 10-percent U.S. shareholders currently on their pro-rata share of that income.

One category of income that is considered subpart F income is "foreign personal holding company income." Foreign personal holding company income generally consists of passive types of income such as interest, dividends, annuities, and net gains from the disposition of certain types of property. Subject to a number of exceptions, foreign personal holding company income includes the excess of gains over losses from transactions (including futures, forward, and similar transactions) in any commodities. Under one such exception, gains and losses from commodities transactions are not taken into account for purposes of measuring foreign personal holding company income if they are "active business gains or losses from the sale of commodities, but only if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler or commodities.[1]

Current temporary regulations interpret the statute by determining the amount of business that is "substantially all" of the CFC's business using a taxable income test.[2] Under the regulations, substantially all of a controlled foreign corporation's business is considered to be as an active producer, processor, merchant, or handler of commodities if its active commodities business operations give rise to at least 85 percent of its taxable income for the taxable year.

The legislative history to the Tax Reform Act of 1986 specified that the exception for active producers, processors, merchants, and handlers of commodities applies only to foreign corporations actively engaged in commodities business.[3] It does not apply to foreign corporations primarily engaged in such financial transactions as the trading of futures. In order to be engaged in the active conduct of a commodities business, a controlled foreign corporation generally must hold commodities as inventory or similar property and incur substantial expenses in the ordinary course of a commodities business.[4] Regularly taking delivery of physical commodities generally indicates the existence of an active commodities business, but it does not of itself determine the issue. Other characteristics of companies actively engaged in commodities business include: engaging in substantial processing activities and incurring substantial expenses with respect to commodities prior to their sale, including (but not limited to) concentrating, refining, mixing, crushing, aerating, and milling; engaging in significant activities and incurring substantial expenses relating to the physical movement, handling, and storage of commodities, including (but not limited to) preparation of contracts and invoices, arrangement of freight, insurance, or credit, arrangement for receipt, transfer, or negotiation of shipping documents, arrangement of storage or warehousing, and dealing with quality claims; owning and operating physical facilities used in the activities described above; owning or chartering vessels or vehicles for the transportation of commodities; and producing the commodities sold.[5]

Reasons for Change

Under current law, a single corporation may engage in the active businesses of processing wheat into flour and of processing oranges into juice concentrate, without generating subpart F income. Similarly, a single corporation may engage in the steel business without generating subpart F income under current law. By contrast, a single corporation that engages in both the active wheat processing business and the steel business loses deferral on its wheat business income. Furthermore, a single corporation engaged in the active wheat processing business, that also earns commodities income from other activities which do not satisfy the active business requirements for exclusion from subpart F, generates subpart F income from both activities if the active wheat business did not constitute substantially all of its business as interpreted by Treasury regulations. The Committee believes that a controlled foreign corporation should be permitted to avoid subpart F treatment of its active wheat business income in both of the latter two cases, whether or not the active wheat processing business constitutes substantially all of its business. On the other hand, the committee believes that it is appropriate to continue to subject to current U.S. income tax net gains from primarily financial transactions involving commodities that do not qualify for the present-law exception for bona fide hedging transactions.

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[1] Other exceptions to the subpart F income classification of commodities gains and losses include an exception for bona fide hedging transactions and an exception for certain foreign currency gains and losses.

[2] Temp. Treas. Reg. sec 1.954-2T(f)(3)(iv).

[3] S. Rep. No. 99-313, 99th Cong., 2d Sess. 367 (1986).

[4] Temp. Treas. Reg. sec. 1.954-2T(f)(3)(iii).

[5] S. Rep. No. 99-313, at 367-368.

Explanation of Provision

The bill expands the exception from the definition of foreign personal holding company income for active business gains and losses from the sale of commodities. Under the provision, active business gains and losses from the sale of commodities by a controlled foreign corporation as an active producer, processor, merchant, or handler of commodities are not taken into account for purposes of determining the foreign corporation's foreign personal holding company income. Thus, the bill eliminates the "substantially all" requirement of present law. As under present law, the exception does not apply to any gains or losses of a foreign corporation derived from primarily financial transactions (e.g., the trading of commodities futures), even if the foreign corporation also is engaged in an active commodities business as a producer, processor, merchant, or handler.

The bill does not alter the present-law criteria for determining whether a foreign corporation is an active producer, processor, merchant, or handler of commodities. Thus, for example, in order to exclude commodity gains and losses under the active business exception, a controlled foreign corporation must hold the commodity giving rise to the gain or loss as inventory or similar property, and must regularly engage in the production, processing, or handling and storage of the commodity.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1992.

FEDERAL TAX INCENTIVES
FOR
PROPER STEWARDSHIP OF THE FORESTS

Position Paper
Prepared on behalf of

DELSON LUMBER COMPANY
HARDEL MUTUAL PLYWOOD CORPORATION
MANKE LUMBER COMPANY
CONIFER PACIFIC

May 22, 1993

The above domestic manufactures request that the following actions be taken for the benefit of preserving ancient forests, the viability of our forest products industry and the integrity of our rural communities:

I. TAX INCENTIVES FOR PROPER STEWARDSHIP OF THE FORESTS.

A. Capital Gains for Sales to Domestic Mills. That the President propose changes to the tax laws to reinstate the preferential capital gains tax treatment, but only for sales of timber to domestic mills.

B. Estate Tax Incentives. The President could propose a variety of estate tax incentives as detailed above to encourage families to hold and properly manage their private timberlands for the benefit of their children and grandchildren.

C. Income Tax Jobs Credit. The President could propose the addition of employees of domestic wood processors to the list of targeted groups under IRC Section 51 as an incentive for domestic mills to create jobs in an high unemployment industry, and thereby creating a reduction in operating costs for these mills.

D. Expanded Reforestation Tax Incentives. The President could also propose an expansion of the current reforestation tax incentives under IRC Section 194 and 48(b).

II. TAX DISINCENTIVES

A. Elimination of Foreign Sales Corporation Tax Subsidy. That the President eliminate the existing rewards for foreign sales corporations which export the raw log and encourage the export of finished products instead.

B. Log Export Tax. The President could also propose a new tax on the export of private timber similar to the Canadian system. Canada exports more finished wood products than any other country in the world.

III. LOG EXPORTS

A. State Log Exports. That the President declare state timber to be in short supply under the Export Administration Act and, therefore, not surplus to the needs of domestic mills; thereby, prohibiting the export of state timber.

B. Log Export Loopholes. That the President propose legislation to finally close all remaining loopholes in federal log export legislation including regulations regarding substitution and replace the state log export prohibitions contained in the Act which was recently declared unconstitutional.

C. Alaskan Western Red Cedar. That the President immediately halt the export of Western Red Cedar off the Tongas National forest in Alaska using the same emergency provisions under the Export Administration Act.

D. Western Red Alder Exports. The President should prohibit the export of Western Red Alder from public lands in order to support the retooling by domestic mills who are presently trying to manufacture a finished product out of alder for the export market.

E. Open Bidding on National Forests in Alaska. The President should direct the Secretary of Agriculture to open bidding on national forests in Alaska to all U.S. mills not just to domestic mills in Alaska; thereby, treating these forests the same as all other national forests in other states.

IV. RETOOLING NOT RETRAINING. Finally, the President should propose grants and or financing assistance for small mills who are retooling to cut second growth, value-added products for domestic sale as well as export.

Retooling these mills, preserving these high quality manufacturing jobs and the infrastructure which provides affordable wood and paper products for our nation should be our priority, not retraining for low quality service-based jobs which do not exist in the cities.

Thank you in advance for the opportunity to comment and your careful consideration of these proposals.

STATEMENT FOR THE RECORD

HEARING ON HR 1997
THE AMERICAN TIMBER SUPPLY AND MANUFACTURING INCENTIVES ACT

BEFORE THE SELECT REVENUE MEASURES SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE

By M. J. "Gus" Kuehne, President
Northwest Independent Forest Manufacturers
P. O. Box 11346
Tacoma, Washington 98411
206-564-0452

Washington, DC
June 24, 1993

Mr. Chairman and members of the committee, I am M. J. "Gus" Kuehne, President of Northwest Independent Forest Manufacturers. NIFM is an association of 40 small and medium sized companies which manufacture lumber, veneer, plywood, shakes and shingles, and harvest timber from public lands in Washington State. Three years ago, when I last testified before the House of Representatives on the log export issue, our association represented 60 companies. The one-third decline in our membership is representative of the decline in forest products manufacturers throughout the northwest because of critically short log supplies.

While previously our member companies were primarily dependent on national forest timber for their log supply, today our members depend heavily on timber from private lands to meet their log supply needs. Timber sales on federal lands in western Oregon and Washington during 1992 were only 10% of the historic levels of the late 1980s.

For obvious reasons the passage of HR 1997 is of major importance to independent forest product manufacturers in the northwest. In fact, rarely does a piece of legislation so perfectly fit the needs of the times as does HR 1997. The Pacific Northwest is both the area of the country with the most critical shortage of logs, and the area where the most logs are being exported. Unquestionably HR 1997 has the greatest potential of mitigating impacts of reduced federal timber harvest of any actions being contemplated by the Clinton administration or Congress. We strongly urge this legislation be passed into law as soon as possible to cushion the impacts of declining federal timber harvests that are so devastating this industry.

We believe it is ludicrous for the United States to continue to subsidize the export of raw logs. Granting a special tax treatment so that U.S. Foreign Sales Corporations get tax breaks for selling logs to mills in Tokyo, Seoul and Shanghai makes no economic sense while mills in Tacoma, Portland and Roseburg are forced to close because of log shortages.

THE SITUATION

Over the past six years the volume of federal timber under contract has declined dramatically in Oregon and Washington, as the volume of timber sold on federal lands has declined by nearly 90%. This has forced over 150 mills to close over this period, see Table 1.

President Clinton is currently considering a forest plan for federal lands in the northwest that will permanently reduce the volume sold annually by from 2½ to 4 billion board feet from the historic levels sold during the late 1980s. This will unquestionably mean further mill closures as volumes under contract disappear.

We believe the major focus of an effort to mitigate this loss of timber supply from federal lands should be to reverse the disincentive provided by log export subsidies and instead provide incentives for domestically processing this timber. This reversal in tax policy to encourage manufacturing finished products in the United States will help to reduce timber supply shortages in the northwest by from 500 million to 1 billion board feet annually. This alternative source of timber supply could offset as much as one third of the decline from federal lands. The reversals in tax policy from subsidizing log exports to incentives for domestic processing under HR 1997 will result in a $100 to $150 per thousand board feet shift in value toward domestic processing.

Russia, Chile and New Zealand are becoming significant log exporter nations. Coupled with the shift in tax policy under HR 1997 log importing countries of the Pacific Rim will look toward these other sources of log supply. This will make northwest log supplies from private lands available for meeting the U.S. domestic market for lumber and plywood.

The U.S. is a net importer of solid wood products, importing some 30% of the lumber being consumed in this country. Lumber being manufactured into wood products in this country will also increase byproduct chips used in paper manufacturing. This should help make building materials and paper products affordable to U.S. consumers.

Housing affordability is a major issue in the nation's economic recovery. As more public timber is processed in the northwest, it will help hold lumber prices at affordable levels so that the home building industry can again lead the U.S. economy from recession.

While these trade adjustments could result in a negative impact on our log exports to Japan, China and Korea, there will be an offsetting reduction in lumber imports from Canada slightly exceeding the dollar value of reduction in log exports. Thus the net impact will be a slight reduction in our foreign trade deficit.

SUGGESTED AMENDMENTS

We recognize that it is important that this legislation not increase the horrendous budget deficit this country is incurring. The amendments we suggest will target tax incentives so that they have the least possible impact on government revenues while maximizing their benefit to the economy. In that spirit we offer the following suggestions to amend HR 1997 to make the law revenue-neutral:

1) Rather than applying to all private lands in the U.S., we suggest it be limited to areas where log exports have historically exceeded 10% of the timber harvested from private lands. This would limit its impact to the northwest, and reduce the revenue impact by 75%.

2) The size of the timber be limited to larger size logs that are actually being exported as raw logs; logs 16 feet and longer and 8 inches in diameter and larger on the small end. Timber smaller than this would not normally be exported and would therefore not require the benefit of tax incentives to be processed in the U.S. It is estimated this would further reduce the revenue impact by 25%, for a total reduction for 1) and 2) of just over 80%.

3) The amount of the reduction (30%) apply to all private lands regardless of the period held. While this would increase the cost slightly, it would greatly reduce administrative costs. Also, the tax rate reduction would not interfere with necessary forest land transactions, especially those that occur on non-industrial lands for estate tax purposes and to meet special revenue needs of small forest landowners. It would also serve the purpose of the legislation better than adjusting the tax incentive to the length of time timber is held.

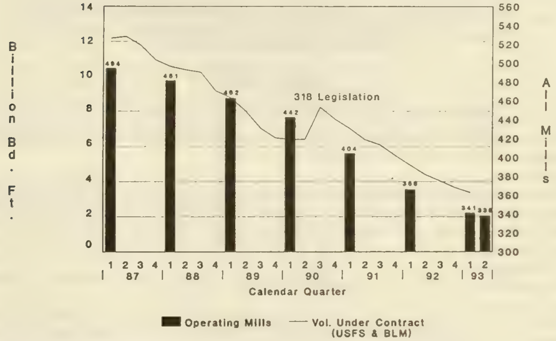
4) A sunset provision be placed on the legislation with an opportunity for renewal. We suggest a five year limit, with a study required one year prior to the expiration of the legislation. The Secretary of Agriculture would be required to determine the effect of the legislation and suggest changes to improve its effectiveness or recommend its termination.

CAPITAL GAINS TREATMENT FOR FOREST LANDS

We do not feel HR 1997 is in conflict with or an alternative to HR 960, the Reforestation Tax Act sponsored by Congressmen Wyden and Kopetski, or any other legislative proposal for capital gains treatment of timber. We believe that act has completely differing goals and should be considered on its own merits. The purpose of HR 960 is to encourage growing continuous crops of trees on private forest lands. The intent of HR 1997 is to encourage the sale of logs in the northwest to domestic manufacturers and thus help to mitigate the impacts of reduced federal timber harvest in the northwest.

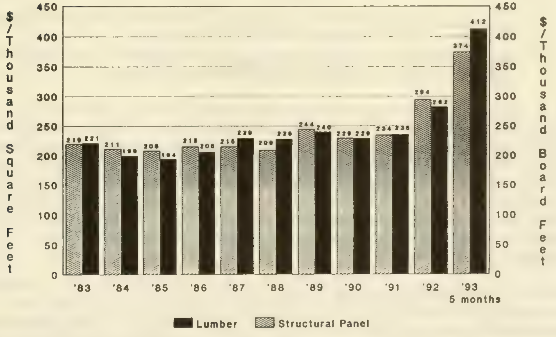
In summary, HR 1997 amended as we suggest would be a revenue-neutral approach to assuring reduced economic impact of any reduction in federal timber harvest in the northwest. It will not only have positive impacts on the northwest economy but will also provide necessary lumber and plywood at affordable prices so that the country may again benefit from a housing-led economic recovery.

TABLE 1
FEDERAL TIMBER UNDER CONTRACT - WA/OR COMPARED WITH OPERATING MILLS



Source: P. F. Ehinger/Timber Data Co.
Prepared by: Northwest Independent Forest Manufacturers 6/93

TABLE 2
U.S. SOFTWOOD LUMBER AND STRUCTURAL PANEL PRICES FOR PAST DECADE



Source: Random Lengths - Framing Lumber and Structural Panel Composite Price Index
Prepared by: Northwest Independent Forest Manufacturers 6/22/93

STATEMENT OF
CHARLES F. GOFF, PRESIDENT AND CHIEF EXECUTIVE OFFICER
DESTEC ENERGY, INC.

HEARING ON MISCELLANEOUS REVENUE ISSUES

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 24, 1993

Destec Energy, Inc. strongly supports the proposal suggested to modify the "unrelated person sale rule" of Section 29 of the Internal Revenue Code.

Destec Energy, Inc. is an independent power producer and marketer of electricity, thermal energy, and syngas for sales to electric utilities and other energy-intensive industries. One of the ways Destec is addressing the challenge of producing power efficiently, safely, and cost-effectively in the face of depleting energy reserves, increased electrical demand, and environmental concerns is through ongoing development of its coal gasification technology. This technology will take advantage of the country's abundant reserves of coal and lignite.

Destec's process is an emerging clean coal technology, just beginning to gain commercial acceptance in the utility market. Destec has been operating a 161 megawatt power plant using its coal gasification technology at facilities in Plaquemine, Louisiana since 1987. Only recently, PSI Energy, the largest utility in Indiana and the largest user of Indiana mined high sulfur coal agreed to develop a repowering project with Destec.

Coal gasification technology. Coal gasification combined cycle ("CGCC") power generation technology is the cleanest, most efficient, commercially available means of producing electricity from coal. Compared to a conventional coal-fired power plant equipped with scrubbers, a CGCC power plant will:

> Reduce emissions associated with creation of acid rain to levels far below federal Clean Air Act standards, exceeding the performance of conventional coal combustion and cleanup technologies.
>
> Reduce carbon dioxide emissions by 15 - 20%, with the likelihood of further reductions with improvements in the technology.
>
> Eliminate creation of solid waste normally associated with scrubber technology.
>
> Accept a wide variety of coal types ranging from low sulfur subbituminous Western coals or Texas lignite to high sulfur bituminous Eastern coals.

Section 29 limitation. Although Section 29 was intended, in part, to provide an incentive to the ongoing development and commercialization of gasification technology, one of its minor requirements creates an unnecessary administrative burden for companies like ours to qualify for the credit. In short, the unrelated person sale rule retards the effectiveness and efficiency of section 29. Congress intended for section 29 to promote the development of nonconventional energy sources, especially clean-burning gas supplies. It would be sensible for Congress to target the unrelated person sale rule in such a way that would not frustrate the Congressional purpose of section 29, while still achieving any intended purposes of the unrelated person sale rule.

Destec does not seek any tax savings from the amendment. The amendment is not designed to expand the use of the section 29 credit, but only to make the credit more efficient. In the case of qualifying section 29 gas produced from a typical well drilled in a tight sands or other geologic formation, the unrelated person sale rule does not create a problem; such gas is sold to an unrelated person in the ordinary course of business since the fuel cannot practicably be used on the drilling site.

In the case of methane gas produced from landfills, or synthetic gas produced from coal or lignite, however, the unrelated person sale rule does cause a problem. In those cases, the fuel is best used to generate electricity on the production site, and to take advantage of cogeneration technology, as well. For example, in the case where a company installs a facility to produce synthetic gas from coal, as a condition to qualify for the credit, an unrelated person must purchase the fuel before it is used to generate power. With utility companies being the primary customer for coal gasification facilities, the credit is denied due to the requirement that the fuel (synthetic gas) be sold to an unrelated party.

The unrelated person rule in section 29 forces a taxpayer, as a condition for qualifying for the credit, to arrange for an unrelated person to purchase the fuel before it is used to generate power. In other words, rather than simply producing the gas and generating power with it without the involvement of a third party, the taxpayer must bring in a middleman, or take on unwanted business risks.

Revenue impact. We understand that the Joint Committee on Taxation has estimated that the proposed amendment would lose a modest amount of revenue over the next five years. Destec certainly does not expect to realize any tax saving from this change. In fact, we would expect our utility customers to pass on the benefit of the credits to their customers through lower electricity prices.

Summary. We believe that the revenue consequences of modifying this legislation are insignificant, with the real impact of the change being merely to eliminate the red tape that currently exists for structuring coal gasification and landfill gas projects. The change has the added benefit of furthering President Clinton's objective of furthering the development of technologies which can be exported to enhance the competitive position of the U.S. worldwide. Modification of the current law would enable Destec to further advance the technology domestically to assure its soundness and then its onward transferability to worldwide markets.

STATEMENT OF
TAMPA ELECTRIC COMPANY
ON PROPOSED AMENDMENT TO SECTION 29 TAX CREDIT

HEARING ON MISCELLANEOUS REVENUE ISSUES

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

June 24, 1993

BACKGROUND:

First incorporated into the Internal Revenue Code in 1978, the Section 29 credit was intended to encourage the production of alternative fuels which would otherwise not be economical to produce.

The credit has encouraged the production of methane gas from coal seams. It likewise has promoted the development of synthetic gas from coal and lignite, a process that since has spawned a host of new and innovative power plant technologies.

Tampa Electric, in fact, already is planning to construct the nation's first commercial-scale coal gasification, electric generation facility. When this plant goes on line in 1996, this 260-megawatt IGCC (integrated gasification combined cycle) power plant will be the nation's cleanest coal fueled facility.

Tampa Electric's IGCC has been designed to produce a synthetic gas from coal that will be used to fuel a combined cycle power block, one that pairs a combustion turbine with a heat recovery steam generator and steam turbine. This high performance, high output technology provides a sulfur removal capability exceeding the most advanced scrubbers, and as such, will be enormously beneficial to the company's long-term clean air compliance planning. For Customers of Tampa Electric, the IGCC also provides the cost savings associated with the use of abundant, economical coal.

Despite these innovations in technology, the full potential of the Section 29 credit is limited under current law. That's because one of the requirements of Section 29 is that the fuel produced must be sold to an unrelated party to qualify for the credit. If Tampa Electric uses the fuel created to generate electricity which is sold to third parties, no portion of the fuel would qualify for the credit.

To qualify for the credit, Tampa Electric will have to sell either the gasification process or the power block to a third party and then purchase or sell the gas produced to generate electricity. The unrelated person sale rule, as a result, retards the effectiveness and efficiency of Section 29.

The shortsightedness of this requirement was recognized when Section 45 of the Internal Revenue Code was enacted as part of the Energy Policy Act of 1992. Section 45 specifically allows a credit for "closed loop biomass" fuel used to generate electricity for sale to third parties.

If the related party rule under Section 29 were conformed to the Section 45 standard, Tampa Electric would receive the full credit rather than having a part of the credit go to a third party. The credit would be treated as a reduction in our fuel costs and would result in an immediate reduction of electric rates to all customers. To the extent that such reduction in electric rates benefits industrial or commercial customers, it would appear that their taxable incomes would be increased, with a resultant benefit in revenue to the Government.

POSITION:

Section 29 was intended to promote the development of nonconventional energy sources, as a way of lessening dependence on foreign oil. For that reason, we feel that it would be advisable for Congress to modify the unrelated party sale rule in a narrow way which would not frustrate the original purpose of the credit, while still achieving the benefits intended by the rule.

In particular, we feel that in those cases where taxpayers produce synthetic gas from coal or lignite or from the biomass in landfills for use in generating electricity for sale to unrelated third parties, present law is neither necessary nor logical.

Based upon our review, the legislative history of Section 29 of the Internal Revenue Code does not contain any purpose for the unrelated party sale rule. Similarly, the legislative history of the Code does not explain why a similar rule was not included in section 45.

Based on the foregoing, we strongly urge Congress to adopt the proposed modification of Section 29. We believe that such modification would uphold the original intent of the credit and that such benefit would be immediately passed through to customers.

Absent such modification, Tampa Electric would be placed in the position of selling either the gasifier or the power block to an unrelated third party, to conform to the current provisions of the Code. This business structure would not insure that the benefits of the credit would be realized by customers, both residential and commercial.

STATEMENT OF
RICH HEFFELFINGER, PRESIDENT

INDEPENDENT OIL AND GAS ASSOCIATION OF WEST VIRGINIA
BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON THE NEED FOR A MARGINAL WELL DRILLING INCENTIVE

Thursday, June 24, 1993

INTRODUCTION

Mr. Chairman, my name is Rich Heffelfinger and I am making this statement today in my capacity as President of the Independent Oil and Gas Association of West Virginia. I would like to thank you for this opportunity and for the concern and consideration you are showing our industry and association.

IOGA-WV is an association of independent producers, service companies, equipment suppliers, royalty owners and other individuals and companies who are involved in the development and production of oil and natural gas in the state of West Virginia. IOGA's more than 350 corporate members represent the majority of the states oil and gas drilling and production activities, and employ a large percentage of the more than 10,000 people employed in oil and gas activities in the state.

Natural gas is key to our industry and West Virginia. This clean-burning fuel represents about 95% of the value produced by the industry in our state, with the remaining 5% being Pennsylvania grade crude oil. As you know, domestic gas and oil can help reduce the balance of trade deficit and our national reliance on imported energy from politically unstable regions. Natural gas is friendly to the environment, producing virtually no sulfur dioxide and volatile organic compounds, and substantially less carbon dioxide than other fossil fuels.

West Virginia is located in the Appalachian Basin, the most mature gas and oil producing area in the United States. For more than 120 years oil and gas have been drilled and produced in this area. The easy resources are gone. About all that is left is the difficult to develop and produce energy in the so-called nonconventional marginal reservoirs. A marginal well drilling incentive is needed in order for us to develop these challenging resources.

Such incentives in the past proved to be an effective tool in encouraging development of domestic natural gas, helping to limit the growth of imported oil and gas and helping reduce the balance of trade deficit. It helped maintain a minimal level of drilling activity, necessary to sustain the drilling and completion service industries from extinction in the Appalachian Basin, as well as a number of other areas of the country. Even with past credit drilling activity was very low; without such an incentive activity has all but ceased in our area.

Drilling in West Virginia, and much of the nation, is at an all time low. In 1982 more than 2,100 wells were drilled in West Virginia. Last year we drilled less than 700 wells. In 1982 we employed more than 6,000 people in direct drilling related jobs. In 1992 that number had dropped to only slightly more than 3,000. This drop in drilling and employment is not unique to West Virginia, rather it characterizes our industry nationwide.

Our need for a marginal well drilling incentive is a unifying issue within our industry. We all realize that it is the only way to revive our domestic natural gas and oil industry. Our need for a marginal well drilling incentive is a jobs issue. Our need for a marginal well drilling incentive is an energy independence issue. Our need for a marginal well drilling incentive is an economic issue.

Most importantly it is a survival issue for thousands of natural gas and oil production companies and the support industries which depend upon them. We live in what has been called the "Petroleum Society," and the fabric of that society is starting to rip. Our society demands a dependable supply of natural gas and oil, and that dependable supply can only be insured by a healthy domestic production industry based on small producers and production from marginal wells.

BOB WISE
2D DISTRICT WEST VIRGINIA

COMMITTEES
COMMITTEE ON THE BUDGET
SELECT COMMITTEE ON AGING
COMMITTEE ON
PUBLIC WORKS AND
TRANSPORTATION
CHAIRMAN SUBCOMMITTEE
ON ECONOMIC DEVELOPMENT

Congress of the United States
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Washington, DC 20515-4802

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102 E MARTIN STREET
MARTINSBURG WV 25401
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June 23, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
House Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

Enclosed please find a copy of a recent letter to Treasury Secretary Bentsen from numerous Members of Congress concerning the need to provide assistance to small, independent oil and gas producers.

In connection with the Select Revenue Measures Subcommittee's ongoing hearings, I would appreciate if you could insert the enclosed letter as part of the Subcommittee's record, specifically in the portion of the record related to oil and gas production from marginal wells.

I also want to bring to your attention another submission from the Independent Oil and Gas Association of West Virginia (IOGA). That organization has sent to you copies of testimony it wishes to offer for inclusion in the same proceedings before the Select Revenue Measures Subcommittee. I would like to ask that you include IOGA's statement as part of the record.

Thank you for you attention to this matter. If you should have any questions please call Roger Goodman of my staff at x5-2711.

Very truly yours,

Bob Wise

Bob Wise
U.S. Representative

BW:reg
Enclosure

Congress of the United States
House of Representatives
Washington, DC 20515

31 March, 1993

The Honorable Lloyd Bentsen
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: oil and gas production incentives -- marginal wells

Dear Mr. Secretary:

On behalf of small oil and gas producers throughout the nation, we are writing to urge your consideration of a limited tax incentive to support the depressed oil and gas industry. We are aware that you are now putting the final touches on the tax portion of President Clinton's long-term investment package, and we believe a measure to revive domestic oil and gas production should be a small but important part of that package.

As you know, oil and gas drilling activity by small producers in this country has virtually ground to a halt. At least half a million jobs have been lost in the oil and gas industry over the last decade. The crisis in the oil and gas industry has also affected the health of the domestic steel industry, which has depended heavily on the oil and gas industry in supplying rig equipment, pipes and tubes. The dramatic decline in drilling activity has resulted in a rapid deterioration of the oil and gas industry's production infrastructure.

We have all heard about the tremendous job losses in the oil and gas industry over the last decade, but even more disturbing are the most recent figures of job losses and declining rig counts since the beginning of this year. The tax credit for production of fuels from non-conventional sources ("Section 29") expired for any new wells spudded after December 31, 1992, and as a result the non-conventional oil and gas industry has practically ceased its operations.

There is still a chance to revive our domestic oil and gas industry. Small producers, whose income is derived primarily from wellhead production, need a modest incentive to make their businesses economic. This is especially important for marginal wells, which produce small amounts of oil and gas each day but large amounts over long periods of time. Without some incentive, we believe oil and gas production from marginal wells cannot be viable.

Understanding the severe budgetary constraints but also understanding the need to save a vital domestic industry, we would like you to consider including a modest drilling incentive in the tax portion of President Clinton's long-term investment plan. You will find a separate sheet enclosed outlining the details of a proposed tax credit for oil and gas production from marginal wells. We believe the benefits this incentive would provide would be well worth the limited revenue loss to the federal treasury.

We look forward to working with you in helping to stimulate domestic oil and gas production by small producers. Thank you very much for considering our views and the enclosed proposal.

Sincerely,

Bob Wise

John D. Dingell, M.C.

Bob Wise, M.C.

Jim Slattery

Charlie Stenholm

Jim Slattery, M.C.

Charles Stenholm, M.C.

Bill Brewster

Glenn Poshard, M.C.

Bill Brewster, M.C.

Rick Boucher

Martin Frost

Rick Boucher, M.C.

Martin Frost, M.C.

Jimmy Hayes

Jimmy Hayes, M.C.

Nick Joe Rahall II, M.C.

Alan Mollohan

Alan Mollohan, M.C.

James A. Traficant, Jr., M.C.

Joe P. M

Glenn English

John P. Murtha, M.C.

Glenn English, M.C.

Charles Wilson

Charles Wilson, M.C.

Ralph M. Hall

Ralph M. Hall, M.C.

Pat Schroeder

Pat Schroeder, M.C.

William J. Coyne

William J. Coyne, M.C.

Billy Tauzin

Billy Tauzin, M.C.

Pete Geren

Pete Geren, M.C.

Jim Barcia

James A. Barcia, M.C.

Jim Chapman

Jim Chapman, M.C.

PROPOSED DRILLING INCENTIVE

Tax Credit for Production from Marginal Wells

a. Newly-drilled marginal wells spudded after July 1, 1993 would be eligible for a production tax credit subject to the following limitations:

(1) **Oil wells producing 50 barrels per day or less** would receive a production credit for the first 15 barrels produced per day.
(On an annualized basis, oil wells producing 18,250 barrels or less per year would be eligible to receive production credits for the first 5,475 barrels produced.)

(2) **Gas wells producing 300 mcf per day or less** would receive a production credit for the first 90 mcf produced per day.
(On an annualized basis, gas wells producing 109,500 mcf or less per year would be eligible to receive production credits for the first 32,800 mcf produced.)

(3) For wells producing both oil and gas, a conversion ratio of 6 mcf per barrel of oil would be used to calculate equivalent oil production, and eligibility for the production credit would be determined by adding barrels of oil produced to the oil-equivalent of gas produced from each well.

b. The tax credit for producing oil and/or gas from marginal wells would amount to the following:

(1) **$3.00 per barrel** of qualified oil produced

(2) **$0.50 per mcf** of qualified gas produced

(3) Oil or gas produced from wells in "**Tight Sands**" or "**Devonian Shale**" formations would receive a tax credit at the same rates as were available under the previous Section 29 regime, subject to the production limitations outlined above.

Statement of
Robert C. Williams, Jr.
Director of Tax
Columbia Gas Development Corporation
Before
Subcommittee on Select Revenue Measures
The Committee on Ways and Means
United States House of Representatives

June 24, 1993

Mr. Chairman:

My name is Bob Williams. I am the Director of Tax for the Columbia Gas Development Corporation which is headquartered in Houston, Texas, and am testifying on behalf of a group of companies that also includes Consolidated Natural Gas Company, Enserch Corporation, Public Service Electric and Gas Company, National Fuel Gas Distribution Corporation and others.

We urge the adoption of legislation to allow natural gas producers which sell natural gas or natural gas products through an affiliated regulated utility to be classified as "independent producers" for Federal tax purposes. This treatment would simply allow us to compete on the same terms as our competitors in the gas industry, rather than being treated as though we were major oil companies with retail gasoline stations.

Background

The federal income tax laws distinguish between "independent" and "integrated" oil and gas producers. Certain tax benefits, such as percentage depletion and the immediate write-off of all intangible drilling costs, are available to independent producers, but not to integrated companies.

This distinction was established in the Tax Reform Act of 1975, which was enacted in the wake of a foreign oil embargo and resulting increase in oil prices. As you will recall, at that time there was substantial public concern about significant increases in the price of gasoline at the pump.

The Ways and Means Committee, in its report accompanying the 1975 Act, made clear that it believed that the largest 25 oil companies, who had reaped windfall profits arising from foreign oil price increases, did not need percentage depletion nor immediate write-off of intangible drilling costs in order to have sufficient capital to continue domestic exploration.

On the other hand, the Committee recognized that other producers continued to need incentives such as percentage depletion and intangible drilling costs in order to continue their exploration for domestic sources of natural and oil. In fact, the committee report accompanying the 1975 legislation acknowledged that "virtually all" independent producers would continue to receive the tax incentives as under prior law.

The Problem

Unfortunately, the legislation enacted in 1975 has the effect of treating natural gas systems the same as the major oil companies, even though their operations have little in common. Years of federal price regulation of natural gas had led to a decline in drilling and shortages of supply. By 1975 many in Washington were projecting that this country would soon run out of natural gas. In fact, the Natural Gas Policy Act of 1978 assumed that by the end of this century natural gas supplies would only be available for residential purposes, and would be priced at the equivalent of $60 to $70 per barrel of oil.

The shortages of the seventies led many natural gas systems to establish their own production affiliates. Federal and state regulators encouraged these production affiliates, recognizing that every effort had to be made to increase domestic gas supplies.

By the early eighties these efforts and the partial decontrol of the wellhead price of natural gas by the early eighties, stimulated drilling activities, and the shortages of the seventies were stemmed.

If those shortage projections had been accurate, perhaps there would be less reason for concern about the tax treatment of the industry. However, not only have the projections natural gas proven wrong, but the industry has grown, and become extraordinarily more competitive. In an environment where the Federal and state governments are now actively promoting a competitive gas market, the need for appropriate tax treatment for natural gas systems is becoming acute.

The specific section of the 1975 Act that is of concern is contained in Internal Revenue Code Section 613A. That section specifies the circumstances under which percentage depletion is available for oil and gas production. The provision that we seek to modify is Section 613A(d)(2), which provides that the percentage depletion tax benefit does not apply to "retailers" (except those with gross receipts under $5 million). This provision also results in the requirement that 30 percent of a retailer's intangible drilling costs be capitalized.

The obvious intent of the limitation was to disallow certain benefits to major oil companies, who were perceived to have the opportunity to raise substantial capital merely by raising the price of gasoline at their gas stations. Unfortunately, Section 613A(d)(2) also excludes a company which would otherwise qualify as an independent producer simply because it is related to a regulated utility that has retail sales of natural gas to residential, commercial and other users. In 1975, the gas industry had not yet emerged as the clearly distinct industry it is today, and the appropriate treatment of natural gas systems with production affiliates was not explicitly addressed.

Regulated Gas Companies Are Different From Gasoline Marketers

Unlike the gas stations affiliated with major oil companies, retail sales of gas companies are subject to state regulation. It is very difficult to convince state regulatory commissions to include in the rates paid by consumers gas a premium to allow for exploration to assure future gas supplies. The state regulators are understandably under great pressure to keep prices for today's consumers as low as possible.

As a result, producers with gas distribution companies are unable to look to their retail sales as a source of substantial capital for domestic exploration and production operations. Therefore, the rationale for the limitation in Section 613A(d)(2) does not apply to our fact situation.

In addition, I probably should explain why natural gas systems like Columbia's cannot look to their interstate pipelines as a revenue source to help fund their natural gas exploration activities. Since the early eighties, the Federal Energy Regulatory Commission (FERC) has issued a series of orders which basically decontrol the interstate pipeline industry. Prior to these orders, pipelines go out and contract with producers for gas supplies, then resell the gas to local distribution companies (LDCs). The FERC orders basically eliminated this pipeline "merchant" function. Instead, LDCs and industrial users now contract directly with the producers for their gas supplies, and the interstate pipelines transport the gas on their behalf without even taking title to it.

As a result of this restructuring of the industry, interstate pipelines have been spending billions of dollars to buy their way out of their contracts with producers. In many instances, including Columbia's, pipelines have been unable to recover many of these reformation costs, and thus their earnings have been substantially reduced. These economic pressures have created an even greater need for producers affiliated with natural gas systems to be able to avail themselves of the production incentives accorded to similar producers.

Present Law Forces Corporate Restructuring to Save Taxes

The arbitrary nature of the limitation on retail sales by regulated gas companies is underscored by the fact that a growing number of gas companies have been able to obtain independent producer status for all or part of their production by restructuring their operations. The Internal Revenue Service has issued rulings which permit a gas system to avoid or mitigate the Section 613A limitation simply by establishing a separate subsidiary which sells none of its own production through affiliated utilities. For instance, we at Columbia have recently been forced to restructure part of our operations to protect independent status for at least part of our production. For other parts of our operations and for similarly situated companies, however, there are regulatory, geographic or other business reasons which make restructuring simply for equitable tax treatment infeasible.

The Amendment Furthers Good Energy and Environmental Policy

In addition to tax fairness, there are many good public policy reasons to correct the problem under Section 613A. The limitation runs counter to this country's energy and environmental policy by discriminating against domestic gas producers who -- although commonly categorized as "independent producers" -- are affiliated with regulated gas utilities.

First, this country's energy and environmental policy relies on increased use of natural gas. The Energy Policy Act of 1992, the 1990 Clean Air Amendments, and the President's economic package rely on the expanded use of domestic natural gas to address environmental concerns and reduce dependence on foreign oil. Many majors are largely shifting their exploration and production activities overseas. In fact, nearly 80 percent of the majors' capital budgets are for foreign operations. This means the country must increasingly rely on domestic independent producers (including those affiliated with integrated natural gas systems) to produce domestic oil and gas.

Second, FERC and other Federal and State policy initiatives are creating an open, competitive gas market including flexible, creative marketing activities. When Section 613A was written, the production arm of a natural gas system could guarantee that none of its own produced gas would flow to the customers of an affiliated utility. Today, operation of the Section is inconsistent with the goals and realities of the fluid new gas market. While recent Internal Revenue Service rulings have added some taxpayer flexibility, a statutory change is needed to reconcile the Code with FERC Order 636 and other gas policy.

In short, it is arbitrary and inconsistent with Federal energy policy to distinguish among similar gas companies on the basis of the downstream flow of their production, and to continue tax rules that reduce the flexibility of gas companies to serve the public in the most efficient manner possible. There is simply no reason to distinguish among essentially similar gas systems which are attempting to meet the Federal policy mandate and the demands of the new and open gas market.

Revenue Impact

Earlier this year, the American Gas Association undertook a comprehensive survey of its members which comprise over 95 percent of the gas companies in this country. They found that thirteen companies across this country would potentially be affected by the proposed change in Section 613A. We followed up with each of these companies to determine, under current projections of price and demand, precisely what the revenue impact of this proposal would be. Based on this effort, we calculated that the five-year reduction in revenues attributable to this proposal would be $51 million, taking into account both regular and alternative minimum tax.

This estimate, however, does not take into account the possibility that even more companies will restructure to avoid retail sales by related companies. As I mentioned earlier, Columbia recently decided to restructure part of our operations to meet the requirements of Section 613A. I expect that others may also do the same. Thus, we believe that our revenue estimate is very conservative.

However, despite having receiving this data, the estimators of the Joint Committee on Taxation have not reduced their five-year estimate of $136 million from last year. We respectfully suggest that this estimate should be reduced to 4 reflect our data.

Conclusion

Last year, the Senate approved a solution to the problem. The Senate version of H.R. 776, the Energy Policy Act, included an amendment to Section 613A which would have corrected the "independent producer" definition so that gas companies would not be denied independent producer status solely because an affiliated regulated utility engaged in sales of natural gas or natural gas products. This correction of the definition of "independent producer" is a fair result that is consistent with good tax, energy, and environmental policy. Last year this legislative change made substantial progress. We urge that it will be enacted this year.

STATEMENT OF LEIGHTON STEWARD
ON BEHALF OF
LOUISIANA LAND & EXPLORATION COMPANY

Before The Subcommittee on Select Revenue Measures of the Committee on Ways and Means Regarding Miscellaneous Revenue Issues

June 24, 1993

My name is Leighton Steward. I am the Chairman, President and Chief Executive Officer of Louisiana Land & Exploration Company ("LL&E"). I appreciate the opportunity to present LL&E's views to the Subcommittee with respect to a proposal to amend Section 613A of the Internal Revenue Code (the "Code") that appears on the Subcommittee's listed measures in item numbered 4 of the provisions related to natural resources.

In general, Section 613A of the Code permits independent producers of oil and natural gas to continue to obtain percentage depletion on a portion of their production. To distinguish independent producers from the large integrated oil companies, the section disqualifies producers who have more than a significant amount of retail sales or refinery production. These producers with refining operations, otherwise qualified, are denied independent producer status if their refinery runs "on any day during the taxable year" exceed 50,000 barrels. This means they cannot claim percentage depletion or deduct 100% of their intangible drilling costs under Section 291 of the Code.

LL&E is engaged in the conduct of exploration and production activities in the United States and certain foreign areas. In 1975, LL&E built a 30,000 barrels per day refinery in Mobile, Alabama, at a cost of $19 million. In 1980, an expansion was begun to increase capacity to 74,500 BPD at a cost of $85 million. Due to the tax penalties in Section 291 enacted in 1982 that would accrue to independent producers if they exceed the 50,000 BPD limit, LL&E has restricted refinery runs in 9 of the last 13 years, (including 1993) to under 50,000 BPD. During that same period, LL&E has been forced to make significant environmental compliance expenditures, including $2.5 million for a waste water treatment plant (which also added $300,000 per year in operating costs), $6 million for diesel desulfurization, $4 million for reducing gasoline RVP, and $1 million for other projects such as storm water management and NESHAPs compliance. In addition to the capital and operating cost of these units, the refinery has had to add 16 employees to operate the units and 6 more to comply with other EPA/OSHA standards imposed on the industry. With the 50,000 BPD restriction, LL&E cannot either economically or efficiently operate its existing refinery and hope to recover the above mandated costs.

Producers such as LL&E with refining capacity just above the 50,000 BPD limit must decide at the start of each tax year whether the marketplace will justify forgoing the tax benefits associated with independent producer status for potentially higher earnings that would accrue from refining runs in excess of 50,000 BPD barrels on any day in the taxable year. Because of today's narrow margins in the refining industry, LL&E has been forced to maintain its refinery's production below 50,000 BPD – that is, at a level that is significantly below the refinery's optimal level of production.

We submit that the 50,000 BPD limit in Section 613A represents bad tax, economic, energy and environmental policies.

The limitation is bad tax policy because it forces producers/refiners to make uneconomic choices based not on market needs but on tax considerations. It is bad economic policy because tax decisions override efficient economic use of refinery assets. It is bad energy policy because it acts as a disincentive to refining during a period when this nation faces a shortage of refining capacity. It is bad environmental policy because it prevents producers/refiners from using the economies of scale to produce the additional revenues necessary to pay for the rapidly expanding costs of compliance with our environmental laws.

The proposal before the Subcommittee would make two changes in Section 613A(d)(4). It would substitute "75,000" BPD for the current law "50,000 "BPD and would provide that the 75,000 BPD limit is to be determined on the basis of the average refinery runs during the taxable year rather than on a day-to-day basis. LL&E strongly urges the Congress to enact this proposal.

The 50,000 BPD any day limit is outdated. The Section 613A independent producer exemption is designed to distinguish between independent, relatively small, oil and gas producers and major integrated industry giants who actually engage not only in production but in refining and marketing, as well. These major corporations generally operate refineries with capacities in excess of 150,000 barrels. The 50,000 BPD test, which was adopted in 1975 when Section 613A was enacted, no longer reflects the true nature of the domestic refinery industry.

In this context, last year the Small Business Administration ("SBA") adopted a final rule revising its size standard for the petroleum refining industry by increasing the capacity limit from 50,000 to 75,000 BPD. In taking this action, the SBA made the following observations (57 Fed. Reg. 18810, May 1, 1992):

> Since the current size standard was established in 1975, the number of small refiners as well as their share of the industry's refining capacity have steadily diminished. Since 1975, most refineries with less than a 10,000 BPD refining capacity and almost half of the refineries with between 10,000 BPD and 50,000 BPD capacity are no longer operating. During this 16-year period the trend has been an increase in refineries with over 100,000 BPD refining capacity. In 1975 small refiners accounted for 7.8 percent of the U.S. refining capacity while by 1989, this share had decreased to 6.7 percent. New environmental compliance requirements may further diminish the small business share of industry capacity. A heavy investment is expected to be needed to change refining processing equipment and some small firms may not be able to meet the investment requirements.

The very factors cited by the SBA, the diminishing size of the small refinery segment of the industry and the increased costs of operations and investment required to comply with environmental laws, also favor providing the incentives under Section 613A of the Code to independent producers who operate refineries with capacities of up to 75,000 BPD. Such an amendment would simply recognize the changes that have taken place in the refining industry over the past 18 years.

One final comment. Under current law a producer/refiner loses its independent producer status under Section 613A if on any day during the taxable year production runs exceed 50,000 BPD. As a result, small refineries must be operated at a lower level than 50,000 BPD so as not to inadvertently exceed the limit. These precautions plus the necessary and unscheduled shut downs for maintenance and repairs, mean that the average daily refinery production runs will be significantly below that 50,000 barrels. For that reason LL&E strongly recommends the enactment of an amendment of Section 613A to provide that the BPD limit be applied on a yearly average BPD basis. Such a standard would protect producers/refiners from inadvertent loss of independent producer status and would permit them to operate their small refineries more efficiently and in accord with market demands.

I appreciate the opportunity to present the views of LL&E to the Subcommittee and urge the adoption of the proposal contained in item 4 of the natural resources section of the hearing list to amend Section 613A(d)(4) of the Code by increasing the BPD limit to 75,000 by using daily refinery runs for the year to measure qualification.

Written Submission of
MDU Resources Group, Inc.
Before the Subcommittee
on Select Revenue Measures
to the Full Committee on Ways & Means

MDU Resources Group, Inc. (MDU) is a diversified natural resource company having its principal offices in Bismarck, North Dakota. Montana-Dakota Utilities Co., the public utility division of the company, serves customers in parts of North Dakota, South Dakota, Montana and Wyoming. The company, through a wholly-owned subsidiary, owns Williston Basin Interstate Pipeline Company, Knife River Coal Mining Company, the Fidelity Oil Group and Prairielands Energy Marketing, Inc. MDU and its oil and gas subsidiaries have a direct and substantial interest in the hearings pertaining to natural resources tax issues. In particular, MDU and its oil and gas subsidiaries would be substantially impacted by a proposal that would allow sellers of natural gas, through a regulated public utility, to qualify as independent producers and to increase the refinery run threshold which applies for purposes of defining whether the taxpayer is a refiner.

MDU submits the following written testimony for consideration by the Subcommittee. Although MDU supports provision for allowing certain integrated natural gas companies to obtain independent producer status, it opposes any change in the definition of independent producer that would reduce MDU's overall tax benefits.

I. Determination of Independent Oil and Gas Producer Status

Generally, MDU would support a legislative proposal that would amend the manner of determining an independent producer for purposes of the retailer and refiner exceptions of the Internal Revenue Code (Code) so long as MDU is exempt from any incidental and unintended affects of such proposal. In this regard, as MDU understands the concept, the proposal would permit the retail sales of a natural gas local distribution company (LDC) that is related to the production company to be disregarded in determining whether a taxpayer is a retailer. Under the proposal, the LDC's retail sales would not count towards disqualifying a company of independent producer status under the retailer exception thereby allowing a number of regulated natural gas entities to receive percentage depletion.

Currently, a number of natural gas companies are denied the federal tax benefits afforded independent producers because they have producing affiliates which sell some of their production of natural gas directly or indirectly to related companies which in turn sell such gas as retail. A producer of oil or gas is considered an independent producer unless that person or a related person is engaged in a significant amount of retailing or refining activity. A taxpayer meets the retailing exception and is considered an integrated producer if the taxpayer sells oil or natural gas through a retail outlet operated by the taxpayer or related person. The retailer exception applies if the taxpayer has total retail sales exceeding $5 million per year.

MDU's current corporate framework entitles the company to claim percentage depletion deductions relative to its production from certain properties. Although a number of companies are denied Federal tax benefits because of the independent producer provisions, the proposal to change the independent producer status rules will negatively affect tax benefits currently garnered by MDU. Specifically, by expanding the definition of independent producer, MDU would lose significant amounts of otherwise applicable percentage depletion tax benefits. Indeed, over a five year period, if crafted without provision for MDU's current corporate structure, the provision under consideration will cause MDU to lose approximately $1 million in percentage depletion tax benefits.

Conclusion

Although MDU understands the need to change the definition of independent producer for purposes of those companies affected, MDU does not believe that such change should come at its expense. Accordingly, MDU requests that any legislative proposal crafted by the Subcommittee considers and rectifies the anomalous impact of such a change on tax benefits that the company would otherwise receive.

Craig G. Goodman
Vice President
Governmental Affairs

June 24, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Comments on Joint Committee Print JCS-8-93, June 16, 1993, pages 116 and 117

Dear Ms. Mays:

Mitchell Energy & Development Corp. ("Mitchell") is one of the nation's largest independent producers of crude oil, natural gas and natural gas liquids and is also a developer of real estate in Houston and Galveston, Texas. Mitchell opposes any legislative proposal that would expand the statutory definition of "independent producer" without also clarifying existing law. Additionally, Mitchell objects to the establishment of a special class of independent producers that would enjoy certain competitive economic advantages not available to all independent producers. However, Mitchell supports revision of the antiquated provisions of Section 613(d)(2) of the Internal Revenue Code to exclude all references to natural gas or products derived from natural gas.

As described, the above-referenced proposal would expand the statutory definition of "independent producer" by enacting an exclusion solely for regulated natural gas utilities from the retailer prohibitions currently applicable to all independent producers. Mitchell does not oppose treating regulated natural gas utilities as independent producers, but it does oppose excepting only these companies from the retail sales prohibition currently in the statute.

Mitchell is concerned because similar legislation, proposed last year, contained such an exception from the retail sales prohibition. The actual legislative language employed last year inserted new language into a parenthetical exclusion applicable to the bulk sales of natural gas and natural gas liquids without simultaneously clarifying that such an amendment was not intended to disturb the holding in the case of *Witco Chemical Corporation v. The United States* as controlling jurisprudence on the definition of "retail sales". To avoid any unintended interpretation of existing law, Congress should clarify that only those sales "made in small quantities to ultimate consumers for personal use" are intended to be treated as retail sales. Absent such clarification, Mitchell opposes any attempt to change the existing statute as it applies to the retail sales of natural gas or natural gas liquids.

Mitchell submits, however, that original intent of the definition of independent producer is not served by prohibiting the retail sales of natural gas and natural gas liquids. The original definition was enacted as a means to identify crude oil producers that were also refiners and retail marketers of motor gasoline.

Distinguishing between crude oil producers on the basis of sales of natural gas and products derived from natural gas serves no useful policy purpose. Indeed, we submit that such an artificial distinction among crude oil producers may be counterproductive to current U.S. energy and environmental policy. The use of natural gas and natural gas liquids as clean, efficient, abundant and low-cost alternative vehicle fuels is a stated policy of the current administration. Moreover, encouraging new markets for these cleaner burning fuels lowers U.S. trade deficits, increases U.S. economic activity and reduces our reliance on foreign energy sources.

MITCHELL ENERGY CORPORATION 2001 TIMBERLOCH PLACE
P O BOX 4000, THE WOODLANDS, TEXAS 77387-4000 713/377-5790
A subsidiary of Mitchell Energy & Development Corp

Consequently, Mitchell Energy & Development Corp. supports the revision of Internal Revenue Code Section 613(d)(2) by the deletion of all references to natural gas or products derived from natural gas. Such a revision (1) would not affect existing jurisprudence, (2) would avoid creating a special class of independent producer, and (3) would encourage all independent producers to make infrastructure investments to supply cleaner burning alternative vehicle fuels at the same time.

Additionally, deletion of all references to natural gas and natural gas liquids is consistent with the original legislative intent to exclude only gasoline retailers from independent producer status while accomplishing the stated purpose of the current proposal as well. Moreover, Joint Tax Committee analysis concluded that amending Internal Revenue Code Section 613(d)(2) to delete all references to natural gas and products derived from natural gas carries the same revenue impact as the legislative modification proposed last year. See: Letter dated March 5, 1992 to Senator John B. Breaux, from Harry L. Gutman, Chief of Staff of the Joint Tax Committee. (Copy attached).

If Congress wishes to expand the definition of independent producer, we urge it to do so in a manner that provides equal opportunities to all independent producers, and encourages the utilization of natural gas and related products as alternative vehicle fuels. Mitchell opposes any changes to the existing statute that would grant a selective group of companies competitive and tax advantages or inadvertently affect interpretation of existing law.

Thank you for consideration of these comments.

Respectfully submitted,

Craig G. Goodman

cc: The Honorable Mike Andrews
The Honorable Senator John B. Breaux
The Honorable Secretary Lloyd Bentsen
The Honorable Harry L. Gutman

102D CONGRESS, 2D SESSION

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REVENUE ANALYSIS

MAR - 5 1992

Honorable John B. Breaux
United States Senate
Washington, DC 20510

Dear Senator Breaux:

This is in response to your request dated February 4, 1992, for a revenue estimate for a proposal to amend the provisions of section 613A of the Internal Revenue Code relating to the definition of "independent producers" for the purpose of determining percentage depletion and intangible drilling cost deductions. The proposal would remove the references to natural gas in section 613A(d)(2), or alternatively, include in that section the phrase "and sales through a regulated public utility as defined in section 7701(a)(33)" in the two bulk sale parenthetical clauses. It is our understanding that these two alternatives would have the same consequences in terms of their effects on taxpayers. Therefore, we have provided one revenue estimate which applies to either alternative.

The estimated effects of the proposal on Federal receipts are shown in the table assuming it is effective upon enactment (assumed to be April 1, 1992).

Fiscal Years [Billions of Dollars]						
1992	1993	1994	1995	1996	1997	1992-97
-0.1	-0.1	-0.1	-0.1	(1)	(1)	-0.3

NOTE: Details do not add to total due to rounding.
(1) Loss of less than $50 million.

I hope this information is helpful to you. If we can be of further assistance, please let me know.

Sincerely,

Harry L. Gutman

STATEMENT OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES
ON
NATURAL RESOURCES TAX ISSUES
June 24, 1993

The American Gas Association (A.G.A.) is a national trade association comprising some 250 natural gas distribution and transmission companies throughout the United States. Collectively, 90 percent of the gas consumers in this country are served by A.G.A.'s members. Most of these member companies promote energy conservation through incentives to customers and several companies have affiliates which are engaged in oil and natural gas exploration and production. Thus, A.G.A. and its member companies have a direct and substantial interest in this hearing pertaining to tax incentives for energy conservation subsidies and oil and gas exploration and production.

A.G.A. submits the following statement for due consideration by the Subcommittee. A.G.A. supports legislative proposals to: 1) allow gas and electric utilities to currently deduct the amount of energy conservation expenditures paid or incurred during the taxable year; 2) make retroactive to June 30, 1989 the provisions of the "Energy Policy Act of 1992" (EPAct) that would exclude from gross income the value of any subsidy provided by a utility to a residential customer for the purchase or installation of a residential energy conservation measure; 3) allow commercial and industrial customers to fully exclude from gross income incentives provided by the utility to enhance energy conservation; 4) permit certain integrated natural gas companies to obtain independent producer status; and, 5) provide a new tax credit for oil and gas produced from marginal properties. A.G.A. opposes legislative proposals that would limit the oil and gas depletion deduction to the taxpayer's adjusted basis and repeal the oil and gas working interest exception to the passive activity limitation rules.

I. Deduction of Energy Conservation Expenditures

A.G.A. strongly supports a provision of H.R. 2026, "The Renewables and Energy Efficiency Incentives Act of 1993," to affirm a longstanding but sound tax policy which allows gas and electric utilities to deduct energy conservation expenditures in the year in which they are paid or incurred by the utility. The bill will help facilitate the utility's vital role in promoting energy conservation among its customers. This legislation is needed to provide clarity and reverse a recent growing trend of some Internal Revenue Service (IRS) auditors to treat energy conservation expenditures as capital expenses. As such, these expenses would be deducted over a number of years rather than in the year they are made. However, conservation expenditures by utilities traditionally have been deductible as "ordinary and necessary business expenses" in the year they are paid or incurred under Internal Revenue Code §162.

A. Background

In 1991, the national IRS office issued a technical advice memorandum (TAM) to Puget Sound Power & Light Company covering the company's 1979-80 taxes.[1] While the TAM permitted Pugt Sound to expense conservation expenditures, the IRS indicated that the company should capitalize these expenses in the future. The TAM permitted the company to currently deduct energy conservation program expenditures, which included payroll costs, computer services, transportation, office supplies and expenses, advertising materials, equipment costs and insulation wrap. The memorandum suggested that a causal link between conservation expenses and company profits mean the expenditures should be capitalized.

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[1] Tech. Adv. Mem. 9128010 (March 29, 1991).

The Puget Sound case, however, is not clearly definitive. That case involved a decade of disputed tax returns and settlement that contained a complicated method of paying $60 million in back taxes, during years Puget Sound deducted its conservation expenses annually. Puget Sound capitalized those expenses over a 10-year period for ratemaking purposes.

The TAM in the Puget Sound case relied on principles conveyed in Indopco, Inc. v. Commissioner, 112 S. Ct. 1039 (1992). The Supreme Court held that a target corporation in a friendly takeover bid must capitalize, rather than deduct as current business expenses, the investment consulting fees and other expenses it incurred in weighing the bid. That Court's decision turned on the fact that the transactional expenditures produced significant benefits for the company beyond the tax year in question. The underlying rationale of the decision is that as the merger expenditures generate future benefits, expenses associated with the generation of those benefits are to be capitalized over a period of years.

Applying a broad interpretation of the Indopco decision, some IRS agents have attempted to require capitalization of conservation expenditures. This position is predicated on an interpretation of Indopco that would require capitalization of any expenditure that creates a substantial future benefit. Virtually all expenditures are at risk of being capital expenses since nearly every kind of expenditure could theoretically create some type of future benefit. If Indopco were read to apply to all expenditures that create a future benefit, many expenditures that have historically been currently deductible would have to be capitalized. Clearly Indopco could not have been meant to reverse a longstanding tradition of sound tax policy.

The IRS has not stated a definitive position on this matter and there is no single case or pronouncement containing clear IRS policy. The trend by some agents coupled with the level of uncertainty in this area will affect some utility's approach to conservation programs. Since the IRS has not established a sound policy regarding conservation expenditures, the interpretation of current law by its auditors may be inconsistent.

B. Conservation Programs

The recent trend of some IRS agents to require energy conservation expenditures to be capitalized is inconsistent with the policies of state regulators who are encouraging or requiring utilities to spend large sums of money on programs to promote energy conservation. These conservation programs are designed to reduce demand-growth by promoting demand-side energy efficiency and to reduce energy use through cash and other incentives. These programs include, for example, energy efficiency audits, installation and weatherization materials and educational programs. Many state regulators allow utilities to earn a return on conservation cost outlays whenever prescribed energy goals are met. In a reversal of its traditional stance that regulatory accounting does not control for tax purposes, the IRS has cited the ratemaking treatment as the reason these expenses should be capitalized and not expensed. This represents a very dangerous precedent, particularly where, as here, there are divergent policy goals. It must be emphasized that ratebase treatment is solely intended to provide an economic incentive for utilities. The purpose of the tax law is to accurately measure income and to collect tax.

Without legislation, energy conservation programs will be more expensive and utilities will be less likely to offer subsidies to customers who undertake energy conservation measures within their homes and businesses. The IRS policy shift comes at a time when Congress has adopted tax incentives in the EPAct for utility customers to exclude from their gross income the value of any subsidy provided by the utility for energy conservation purposes.

C. A.G.A. Survey

A.G.A. surveyed 50 of its member companies, which comprise half of the top 100 gas distribution companies in the nation[2], to determine the impact of requiring such companies to capitalize conservation expenditures. Of the 50 companies surveyed, 46 responded and 38 indicated that they had conservation programs mandated by regulatory authorities. The 46 responding companies represent 76 percent (approximately $28.5 billion) of the assets of the top 100 gas distribution companies as reported in Pipeline Gas & Journal.

The respondents indicated that they had spent nearly $991 million from 1985 through 1992 on conservation programs. They estimate that over a $1 billion will be spent from 1993 through 1996. The survey showed that 97 percent of the respondents currently deducted their conservation expenditures for tax purposes. If the IRS disallows a current deduction, 36 percent of responding companies indicated having unlikely to no chance of recovery of costs from ratepayers. The companies having little or no chance of recovery also represent 72 percent of energy conservation expenditures. Nearly 26 percent of respondents with conservation programs had been questioned by the IRS concerning the tax treatment of conservation expenses. Those companies questioned account for 53 percent of the cumulative current deductions.

Some utilities may cut their conservation efforts by as much as 10 percent if the IRS requires such expenses to be amortized. This would be contrary to national policy goals of encouraging energy conservation. Under the current IRS trend, utilities may be faced with enormous back tax liabilities for deductions taken in previous years. We therefore urge Congress to enact H.R. 2026 which would enable utilities to currently deduct, consistent with prior tax policy, conservation expenditures.

II. Effective Date of Tax Incentive for Residential Customers

A.G.A. supports a section of H.R. 2026 to make retroactive a provision of the EPAct pertaining to the tax treatment of utility rebates to residential customers. Prior to June 30, 1989, the "National Energy Conservation Policy Act of 1982" excluded the value of any subsidy provided by a utility to a residential customer for the purchase or installation of a residential energy conservation measure from the customer's gross income. The EPAct contained a similar provision for subsidies received after 1992. Thus, subsidies received between June 30, 1989 and December 31, 1992 for residential energy conservation measures would be included in the utility customer's gross income.

We strongly support the proposal to extend the date of the exclusion from June 30, 1989 to the effective date provided by the EPAct (January 1, 1993) as a measure for promoting conservation.

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[2] All companies responding to the A.G.A. survey were listed in "The 300 Leading Gas Distribution Utilities", Pipeline and Gas Journal, Sept. 1992. Seventy seven of the top 100 companies are members of A.G.A.

III. Provide Full Exclusion for Commercial and Industrial Customers

A.G.A. supports a provision of H.R. 2026 that would permit commercial and industrial customers to fully exclude the value of subsidies provided by the utility for energy conservation measures from their gross income beginning after December 31, 1993. The EPAct provides that beginning in 1995 such customers could exclude 40 percent of the value of the subsidy and 50 percent in 1996. We support the legislation provided that the full exclusion is applicable only to those purchases or installations of energy conservation measures which result in a reduction of primary energy consumption and promote national policy goals of a cleaner environment and reduced dependency on imported oil.

Federal conservation tax policy should promote true energy efficiency. While this seems like a simple truism, some programs actually result in increased energy use. Previous public and private sector efforts to establish performance standards and performance measuring systems for products and buildings have dealt with the efficiency of consumption of energy used by the product or the amount of energy consumed at the customer's site. This end-use, site-based approach disregards the inefficiencies that exist between the point of extraction of the resource energy and point of delivery of the energy to the customer for use. Such approach creates significant distortions in the structure and conduct of energy conservation programs and increases energy consumption and consumer energy costs.

We believe the most appropriate means of measuring energy efficiency and developing programs and techniques to promote energy conservation is by "resource energy analysis." This approach measures the amount of energy used or lost in the extraction, processing, transportation, conversion, distribution and use of all forms of energy. The efficiency of resource energy analysis refers to the total amount of energy that must be produced to satisfy a specific end-use energy demand, recognizing that energy is lost at many points along the trajectory. This methodology should apply to energy conservation programs for the utility's residential as well as commercial and industrial customers.

According to A.G.A. data, for example, natural gas is delivered to the consumer at an overall efficiency of 91.2 percent.[3] This means that less than 10 percent of energy is wasted from the time the gas is produced to the point gas is used by the consumer. Electricity generated by burning fossil fuels in existing generating plants is delivered at an overall efficiency of 26.7 percent; electricity generated from new fossil fuel burning generating stations would be delivered at an overall efficiency of 30.4 percent; electricity generated by hydropower would be delivered to the customer at an efficiency close to that of natural gas.

Programs to encourage energy conservation and efficiency might overlook the advantages of using natural gas by focusing on end-use efficiencies. Such programs should focus on the total amount of energy used. Moreover, the legislative proposal should consider the total resources energy analysis approach and environmental standards in determining whether a conservation measure actually reduces energy consumption for purposes of applying the taxable income exclusion. The efficiency rating mechanism should not ignore the big picture in that decision makers should consider the total costs involved when evaluating appliance and building code efficiencies.

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[3] American Gas Association, "A Comparison of Carbon Dioxide Emissions Attributable to New Natural Gas and All-Electric Homes," Planning and Analysis Energy Analysis 1990-5 (Oct. 31, 1990) Arlington, Va.

IV. Determination of Independent Oil and Gas Producer Status

A.G.A. supports a legislative proposal that would amend the manner of determining independent producer status under the retailer and refiner exceptions of Internal Revenue Code §613A(d)(2). With respect to the retailer exception, the proposal would permit the retail sales of a natural gas local distribution company (LDC) that is a related to the production company to be disregarded in determining whether a taxpayer is a retailer. According to the proposal, the LDC's retail sales would not count towards denying the company independent producer status under the retailer exception rule.

A.G.A. has supported previous legislative efforts to allow the production affiliate of certain integrated natural gas companies to be treated as independent producers. This would have permitted them to take tax benefits of percentage depletion and current deduction for intangible drilling costs (IDCs) on their natural gas production and exclude excess percentage depletion and IDCs in computing alternative minimum tax (AMT). Present law provides a deduction to independents from alternative minimum taxable income for their AMT preferences and adjustments related to IDCs and percentage depletion. Integrated oil and gas producers are not allowed to take percentage depletion and they must amortize 30 percent of their IDCs.

A number of A.G.A. member companies are denied the federal tax benefits afforded independent producers because they have producing affiliates which sell some of their production of natural gas directly or indirectly to related companies[4] which in turn sell such gas at retail. A producer of oil or gas is considered an independent producer unless that person or a related person is engaged in a significant amount of retailing or refining activity. A taxpayer is considered to be a retailer and hence an integrated producer if the taxpayer sells oil or natural gas through a retail outlet operated by the taxpayer or related person. The retailer exception applies if the taxpayer has total retail sales exceeding $5 million per year.

While there is limited legislative history, it appears that Congress determined to treat integrated producers differently from independents during enactment of the "Tax Reform Act of 1975." Section 613A of the Code was added by that Act as a reaction to increases in energy prices brought on by the foreign oil embargo. The House Ways and Means Committee Report states that the Committee believed the percentage depletion tax benefit was no longer necessary for the "25 large oil companies" that had reaped windfall profits from foreign oil price increases.[5] The Committee decided to exempt the "smaller producer, or virtually all independents" from general repeal of the percentage depletion provisions because it was believed these companies needed the incentive to continue their exploration of domestic oil.[6]

The Report also sought to treat federally regulated natural gas companies as independent producers with respect to percentage depletion. This was based on the theory that the price established by the then Federal Power Commission (Federal Energy Regulatory Commission) had historically been significantly below the market price, and that percentage depletion was necessary to encourage exploration.[7] The Committee further provided that the percentage depletion deduction would be phased out if the de-regulated price of natural gas were raised to equal or exceed comparable de-regulated oil prices.[8]

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[4] A 5 percent stock ownership is all that is required to meet the related corporation standard.

[5] H.R. REP. NO. 93-1502, 93d Cong., Sess. (1974).

[6] Id. at 6.

[7] Id. at 51.

The Conference Report indicates that the Senate proposed an amendment which would have defined the "small producer" exemption to exclude any producer owning a retail outlet for the sale of natural gas or refining more than 50,000 barrels of oil on any one day of the taxable year.[9] Congress apparently believed the nation's large oil companies that had reaped large profits from foreign oil price increases did not need the tax incentive provided independents to explore and drill.

Unlike integrated oil companies, regulated gas companies have profit levels determined by regulatory authorities and are not in a position to raise substantial capital through their retail marketing operations. Section 613A of the Code treats gas companies like the major integrated oil companies that can raise substantial capital through their gasoline marketing operations. Producers who have gas distribution affiliates cannot rely on retail sales which are regulated by state public utility commissions (PUCs) as a source of substantial capital for their domestic exploration and production operations.

Moreover, state PUCs generally protect utility customers against any cross-subsidizing that might occur between the utility and its affiliates. Natural gas systems, because of their regulated status, are even more in need of tax incentives than many large independent producers, who are unrestricted in their ability to fund exploration and production from the profits of affiliated entities.

There is inequitable treatment among similarly situated taxpayers within the same industry. When a production company sells oil and gas within its consolidated group to a sister company to produce electricity for resale at retail, there are no problems with the group being designated an independent producer. It is only when a production company supplies its sister gas utility for resale at retail that the group can be considered an integrated oil company. There is nothing in the legislative history to suggest that Congress intended to favor electric utilities over gas utilities. This oversight should be corrected.

It is inconsistent with emerging U.S. energy and environmental policy to continue to discriminate against producers with retail natural gas sales. The "Clean Air Act Amendments of 1990" and the "Energy Policy Act" illustrate the expanded role of natural gas to cleaning the environment and reducing dependence on foreign oil. Like other independents, most natural gas systems are struggling to find capital to finance their domestic exploration and production activities. This is a major concern when some of the major oil companies are shifting their production efforts abroad.

V. Tax Credit for Marginal Properties

A.G.A. supports the proposal to create a new tax credit for the sale of domestically produced crude oil and natural gas from marginal properties. The credit will provide an incentive for domestic oil and gas producers to invest time and capital in the exploration and production of oil and gas from deposits that would be uneconomical to develop without the credit. In addition, the credit would be allowed to offset both regular and alternative minimum tax and any unused credit could be carried forward or backward. This will enable producers of marginally producing wells to take full advantage of the credit without restrictions imposed on carry-overs and by the AMT provisions of the Code.

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[8] Id. at 52.

[9] H.R. REP. NO. 94-120, 94th Cong., 1st Sess. (1975).

The term "marginal property" would be defined and computed differently for: 1) newly drilled wells into proven properties (the well is located on property whose per-well production does not exceed 25 barrels of oil and gas a day or 150 Mcf of gas per day); 2) newly drilled wells into unproven properties (credit would equal $0.50 per Mcf for the first 90 Mcf of gas produced per day from the well during the year); and, 3) wells existing on date of enactment of the proposal (credit applies if well is part of a "stripper well property" whose average daily per-well production for the year is 15 or less barrels of oil and gas or 90 Mcf of gas). The proposed credit would not be allowed for production from any well that qualifies for the Section 29 credit for nonconventional fuels.

VI. Limit Percentage Depletion to Adjusted Basis

We urge Congress not to enact a provision of proposed H.R. 2026 that would limit deduction for percentage depletion for oil and gas properties to the taxpayer's adjusted basis in the property. Currently, those entitled to take percentage depletion may do so without regard to the taxpayer's adjusted basis in the property.

We believe those taxpayers, such as independent producers, who can avail themselves of the tax benefits of percentage depletion need such incentives to continue their domestic oil and gas exploration and production activities. This tax incentive helps to make it economically feasible for small producers to drill and operate wells and serves as a source of capital for such projects. It would hamper the exploration and production of many small producers who have had great difficulty remaining profitable over the last decade to have this tax incentive taken away.

VII. Repeal of Oil and Gas Working Interest Exception to Passive Activity Limitation Rules

A.G.A. urges Congress not to repeal the special rule under which oil and gas working interests are excepted from being treated as passive activities. Repeal of the rule would hamper the ability of independent producers, who supply nearly 60 percent of domestically-produced natural gas, to raise capital through joint ventures and partnerships. We urge that the current rule be retained, which would allow working interests in oil and gas properties not to be treated as passive activities.

VIII. Conclusion

A.G.A. supports several proposed tax incentives to increase energy conservation. One such proposal would enable utilities to deduct the amount of energy conservation expenditures paid or incurred during the taxable year rather than over a number of years. Other proposals would expand upon current law which excludes from gross income the value of subsidies provided by the utility to residential, commercial and industrial customers for energy conservation measures.

A.G.A. supports measures that will expand the domestic exploration and production of natural gas. In that regard, independent producer status should be granted to certain integrated natural gas companies who are denied such status merely because some of the gas produced by the production company is sold to a related LDC with retail sales exceeding $5 million annually. These integrated gas companies are not like major oil companies that have greater market power and less regulatory constraints for raising capital for exploration and production activities.

While A.G.A. also supports the proposed tax credit for marginal properties, it opposes the proposal to limit percentage depletion to the taxpayer's adjusted basis and repeal of the rule excepting oil and gas working interests from the passive activity limitation rules.

Statement of

Raymond A. Lewis
President
American Methanol Institute

Before the

Committee on Ways and Means
Subcommittee on Select Revenue Measures

Regarding

H.R. 2026, the Renewables and Energy Efficiency Act of 1993

Washington, D.C.

July 23, 1993

On behalf of the American Methanol Institute, the national trade association for the U.S. methanol industry, I am very pleased to have the opportunity to present this statement for the record on H.R. 2026, the Renewables and Energy Efficiency Act of 1993.

The members of the American Methanol Institute (AMI) produce virtually all of the methanol used as a fuel and as a chemical feedstock in the United States. Methanol is produced almost entirely from abundant supplies of domestic natural gas. In addition, promising technology is being developed also to produce methanol cleanly as a byproduct of domestic steelmaking.

In recent years, the quest for energy diversity has caused an increase in demand for methanol and other alcohol fuels products. Over one-fourth of the methanol currently marketed in the United States is used to manufacture MTBE (methyl tertiary butyl ether), the most widely-used clean-fuel gasoline additive today. Last year approximately 2 billion gallons of MTBE were blended into gasoline.[1]

In addition, all of the major U.S. automakers now sell "flexible fueled" automobiles that operate on methanol, and dedicated methanol-fueled transit and school buses are in commercial use. Plans have recently been announced to create up to 2,500 methanol filling stations across the nation to further establish methanol as a viable alternative fuel nationwide. Indeed, methanol is a remarkably safe, high-performance and efficient fuel, having been used as the sole fuel for the Indianapolis 500 for the past 28 years.

H.R. 2026 Properly Reduces the Subsidies for Ethanol

Section 301 of H.R. 2026 would reduce the enormous tax subsidies that now apply to the ethanol industry. These subsidies are excessive and unfair. AMI strongly supports such a reduction in them.

Currently, Internal Revenue Code provisions afford the ethanol industry tax subsidies amounting to 54 cents per gallon of ethanol, with an additional subsidy of 10 cents per gallon of ethanol given to "small" producers. These subsidies come on top of state and local subsidies of 10 to 50 cents per gallon.

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[1] CRS Issue Brief: Alternative Transportation Fuels: Oil Import and Btu Tax Issues, Updated May 18, 1993, Congressional Research Service, The Library of Congress, p. CRS-6.

AMI agrees with the direction of section 301 of H.R. 2026. The current ethanol tax subsidies are anti-competitive; they injure the unsubsidized domestic methanol industry and impede the development of clean fuels, while enriching an ethanol industry dominated by a single company; and, as we point out below, they are contrary to sound energy, environmental and tax-policy goals. These subsidies should be phased-out or eliminated; at the very least they should be reduced, as H.R. 2026 would do, to achieve a more equitable and level playing field.

Competition between methanol and ethanol. Methanol and ethanol are competing alcohol fuels. Whereas methanol is produced cleanly and efficiently from domestic natural gas, ethanol is produced mainly from corn. Both are used to add oxygen to gasoline. Both also add octane to gasoline, replacing lead and other less desirable octane enhancers. Methanol is commonly added after having been reacted to form MTBE, an ether. Ethanol is commonly splash blended directly into gasoline and can also be reacted to form an ether, ETBE (ethyl tertiary butyl ether). Both can also be burned directly as fuels (M85, M100, E85, E100).

The tax subsidy for ethanol only benefits one of these domestic fuels, thereby injuring the other. Methanol from domestic natural gas, which is not subsidized, is placed at a serious and unjustified disadvantage. An equitable tax system should provide parity on an energy content basis in tax treatment for methanol, ethanol, and other non-petroleum fuels. H.R. 2026 moves in the right direction by reducing the unwarranted ethanol subsidy.

Ethanol efforts to receive still more subsidy. When ethanol tax subsidies were first enacted in 1978, the ethanol industry urged special tax treatment on a temporary basis to enable it to develop the initial production facilities. Now, some 15 years later, ethanol has become a well-entrenched, giant industry in which a single, sophisticated company accounts for 65 to 70 percent of total production.

The ethanol industry no longer has any claim to call itself a fledgling, start-up operation. It produces over one billion gallons of tax-subsidized ethanol annually and is growing. It benefits from environmental waivers from EPA, discussed below, and is also now urging EPA to adopt what would amount to a mandate for guaranteed markets for ethanol under regulations governing reformulated gasoline.

Yet in recent testimony, the ethanol industry not only opposed reducing its enormous subsidy, as H.R. 2026 would accomplish, but actually sought even higher subsidy levels.[2] There is absolutely no justification for increasing the ethanol subsidy. The methanol industry is already at a severe disadvantage under existing law. At the same time, the ethanol industry, aided by inordinately high subsidies, is realizing record profits.[3] The ethanol industry can clearly produce and sell its product profitably without more public assistance from the federal treasury, as confirmed by analysis by the Congressional Research Service. Also, Mr. Eric Vaughn stated in a hearing on February 1, 1990, before the Committee on Ways and Means, that "Since the early

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[2] Testimony on H.R. 2026 by Eric Vaughn on behalf of the Renewable Fuels Association before the Committee on Ways and Means, Subcommittee on Select Revenue Measures, June 24, 1993, pp. 2, 9.

[3] Recent press reports confirm that ethanol producers are not only "enjoying robust profit margins" but have just achieved "the most profitable quarter on record for the fuel ethanol industry." Oxy-Fuel News, March 22, 1993, pp. 1, 4.

1980s, the cost of production has actually fallen in the range of 50 percent from where it was." It is clear that any further subsidy for ethanol would simply deplete federal funds while enriching ethanol producers, artificially expand the market for ethanol at the expense of the unsubsidized methanol industry, and severely undercut the benefits of U.S. methanol production and use.

Ethanol production as non-renewable energy. A further reason for supporting section 301 of H.R. 2026 is that, unlike wind and solar energy, ethanol is not in any accurate sense a truly renewable fuel. Ethanol production is a major consumer of hydrocarbon fuel and is highly energy inefficient. For every Btu of energy contained in finished ethanol, some 0.7 to 1.1 Btu is consumed in the process of producing the ethanol. The high and continuing tax subsidy has insulated the ethanol industry from normal pressures to innovate, while penalizing more cost-effective methanol production. The existing ethanol subsidy rewards energy inefficiency. Section 301 of H.R. 2026 moves appropriately toward correcting this imbalance.

Ethanol production and federal tax expenditures. The federal tax subsidy for ethanol of 54 cents to 64 cents per gallon is already enormous and is growing each year as the volume of ethanol production grows. At current production levels, the tax subsidy amounts to hundreds of millions of dollars per year, most of which benefits a single company.

The ethanol industry has claimed from time to time that this subsidy is really free, since increased ethanol production may lower payments in farm crop-support programs. The fallacy in this argument, however, has been exposed in several key studies. The U.S. Department of Agriculture examined the ethanol subsidy in 1986 and concluded:

> "Subsidies required to sustain the ethanol industry will offset any savings in agricultural commodity programs resulting from the increased demand for corn."
>
> "[P]roduction of fuel ethanol represents an inefficient use of our Nation's resources."
>
> "Any savings in agricultural program costs would be offset by larger ethanol subsidy costs."
>
> "When all economic costs and benefits are tallied, an ethanol subsidy program is not cost effective."[4]

A follow-up study in 1988 concluded similarly, in particular that when the analysis is extended beyond 1995, any "net reductions in farm program outlays are overwhelmed by the added excise tax losses."[5] These studies are consistent with a 1990 GAO report, which reported that "the expanded use of ethanol will cause higher ethanol production costs" and could lead to calls for still greater subsidies; that the GAO study "did not explore all the impacts of expanded ethanol use on the federal budget"; that as ethanol production grows, tax losses become greater and budget impacts become "speculative"; and that "an overall federal budget impact assessment is precluded" in the GAO study.[6] It is all too clear that the ethanol tax subsidy is a major drain on the federal treasury.

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[4] "Fuel Ethanol and Agriculture: An Economic Assessment," U.S. Department of Agriculture, Office of Energy, Agricultural Economic Report Number 562, August 1986, pp. iv, 36, 37, 45.

[5] "Ethanol: Economic and Policy Tradeoffs," U.S. Department of Agriculture, Economic Research Service, Agricultural Economic Report Number 585, April 1988, p. 40.

[6] "Alcohol Fuels: Impacts From Increased Use of Ethanol

Methanol, unlike ethanol, does not seek or benefit from environmental waivers. Methanol and its ether derivatives burn cleanly and provide major benefits in reducing pollution from carbon monoxide (CO) and nitrogen oxides (NOx), while reducing the global warming caused by gasoline. Methanol products have enabled refiners to eliminate the use of toxic pollutants such as lead and to back down the use of benzene in gasoline, a known carcinogen. All of this has been done based on methanol's merits, without any environmental waivers or other favoritism.

Ethanol, by contrast, increases the volatility of gasoline when splash blended, does not reduce global warming effects, and has been criticized as an environmentally unsound product.[7] Its use has been permitted only because some time ago it was granted a one-pound vapor-pressure waiver for blending in gasoline, a waiver that increases the propensity of the gasoline with which it is blended to create urban smog. Section 301 of H.R. 2026 moves in the right direction by reducing the subsidy for such a product.

Methanol is a major domestic industry that will continue to grow if treated fairly. It is important to appreciate that methanol is a major domestic product. In recent years, the domestic methanol industry has expanded rapidly to meet the growing demand for clean fuels and fuel additives. The methanol industry is providing a key market for domestic natural gas, and work is well under way also to produce methanol cleanly as a byproduct of domestic steelmaking. Currently, some 75 percent of the methanol consumed in the United States is produced domestically, with another 16 percent produced from secure natural gas supplies in Canada. An additional 5 percent comes from Latin America and the Caribbean Basin, with only 4 percent produced in other parts of the world.[8]

If permitted to compete fairly, this pattern of strong domestic production and growth will continue. We emphasize the strong domestic nature of the methanol industry because it is important to correct for the record the serious misstatements that the ethanol industry made on this subject in its testimony before this Subcommittee. The ethanol presentation was flatly incorrect in asserting to this Subcommittee that "over half of the alternative oxygenates to ethanol are imported."[9] That is not so now and it will not be so in the future. Methanol will be a major domestic product as long as the tax code and other public policies permit the methanol industry to compete fairly. The methanol industry has significant plans to maintain and increase domestic methanol production, assuming fair treatment.

We note also that the ethanol testimony was incorrect in asserting that the ethanol use significantly reduces U.S. dependence on foreign oil, going so far as to assert that ethanol reduces

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Blended Fuels," U.S. General Accounting Office, GAP/RCED-90-156, July 16, 1990, pp. 5, 25, 30, 31.

[7] Emissions of Greenhouse Gases from the Use of Transportation Fuels and Electricity, Argonne National Laboratory/ESD/TM-22, Mark A. DeLuchi (November 1992); Reducing Greenhouse Gas Emissions with Alternative Transportation Fuels, Environmental Defense Fund, Diane C. Fisher, Ph.D. (1991).

[8] Source: Petrochemical Consultants International, from U.S. Department of Commerce and International Trade Commission statistics.

[9] Testimony of Eric Vaughn, supra, p. 5.

foreign oil imports gallon for gallon.[10] This assertion is patently fallacious. Not only does ethanol production consume major quantities of petroleum and other fossil fuels, but the energy content of ethanol is significantly lower than that of gasoline so that ethanol could not possibly reduce petroleum use on a gallon-for-gallon basis even if ethanol production required no energy. In fact, however, as noted above, ethanol production is a high user of energy and does not produce a favorable energy balance. Methanol production, by contrast, is an energy-efficient process and does not consume petroleum. Unlike ethanol, methanol production truly does increase energy security significantly and reduce imports of petroleum.

CONCLUSION

In summary, the American Methanol Institute supports section 301 of H.R. 2026 because it reduces the unfair and excessive ethanol subsidy and moves in the direction of tax parity among alcohol fuels.

We urge the Subcommittee to adopt the principle of tax parity among non-petroleum fuels as it considers H.R. 2026 and other tax issues involving competing fuels.

CITY UTILITIES of SPRINGFIELD

July 8, 1993

The Honorable Mel Hancock
129 Cannon House Office Building
Washington, D.C. 20515

Dear Congressman Hancock:

Thank you for assisting City Utilities recently when it sought to testify before the Subcommittee on Select Revenue Measures on H. R. 2026, the Renewables and Energy Efficiency Incentives Act, sponsored by Rep. McDermott. I understand that the hearing schedule was so full that it was impossible to accommodate another witness, but I appreciate your efforts on our behalf.

For the record, I want to state that we are strongly opposed to section 302 of H. R. 2026, which would eliminate the use of tax-exempt bonds to construct future coal, oil or nuclear power plants. We believe that this provision violates the principles of federalism and is a serious intrusion on the authority of state and local governments.

Traditionally, tax-exempt financing has been permitted for all activities undertaken by a state or local governmental entity so long as the facilities financed with the bonds are owned and operated by that entity and the benefits of the facility are provided to all its citizens. Within these parameters, decisions about what types of facilities will be financed with tax-exempt bonds are left to the discretion of the state or local governmental body. Section 302 would change this policy and make tax-exempt financing decisions of state and local governments contingent on approval from the federal government.

For many years, City Utilities and municipal utilities across the country have financed electric generation, transmission and distribution facilities with tax-exempt bonds. If future growth and electric demand indicate the need for additional facilities, we would want to be able to finance them in the same manner. Eliminating City Utilities' ability to finance new fossil-fueled generation facilities with tax-exempt bonds would increase our power supply costs and result in higher costs for local ratepayers.

H. R. 2026 is also blatantly unfair to public power systems. If it is indeed to be our national energy policy that there should be no new construction of conventionally-fueled power plants, the legislation should be applied across-the-board to all public, private and rural electric cooperative utilities and to independent power producers. That is not the case with the McDermott bill. H. R. 2026 unfairly targets just one sector of the utility industry - public power - for discriminatory treatment. The bill does nothing to discourage future investment in such facilities by investor-owned utilities. Nor does it eliminate any of the tax benefits related to conventional fuel facilities that those utilities now claim.

Thank you for the opportunity to express these views. I would appreciate it if you could have this letter made part of the hearing record on H. R. 2026.

Sincerely,

Robert E. Roundtree
General Manager

June 30, 1993

Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

As the Committee continues its review of miscellaneous tax measures, the Electric Transportation Coalition wishes to express our support for an amendment to section 179A of the Internal Revenue Code to modify the tax incentive for battery powered electric buses. Such an amendment is contained in Section 201 of legislation currently pending before the Committee, H.R. 2026, the "Renewables and Energy Efficiencies Incentives Act of 1993".

The Electric Transportation Coalition (Coalition) is a national organization of public and private groups interested in the use of electricity as a transportation fuel. (A membership list is attached.) A principal activity of the Coalition is to encourage the adoption of incentive-based policies and programs to support the development and use of electricity as a transportation fuel in the United States.

Electricity offers significant advantages in transportation applications. From an energy security standpoint, electric transportation presents our nation with a very important means to reduce our dependency on foreign petroleum and to increase the diversity of the fuels used in the transportation sector.

Electric transportation also holds the potential to significantly reduce emissions from the transportation sector. Electric vehicles are truly "zero emission" vehicles. They produce no tailpipe emissions and generate insignificant emissions resulting from operation. Unlike other vehicles, EVs are not subject to emission system deterioration over time, and there is no danger of tampering with emission controls. The only identifiable emissions associated with electric transportation are those at the powerplant which generates the electricity used to charge the EV batteries. Powerplant emissions already are subject to rigorous environmental controls; thus, even when powerplant emissions are included, electric transportation offers significant improvements over conventional transportation modes relying on petroleum based fuels.

For urban areas, electric transportation is effective in substantially reducing emissions of major mobile source pollutants, including volatile organic compounds and oxides of nitrogen, that are the precursors of urban smog. In the heavy duty weight classes, the potential for emissions reductions from the substitution of electrically powered vehicles for conventionally fueled vehicles is particularly significant. Air quality considerations have lead municipal transit operators to examine clean fuel bus technologies, including battery powered electric buses. As a result, development programs are underway to lead to the commercial introduction of battery powered electric buses, suitable for a variety of transit applications.

ELECTRIC TRANSPORTATION COALITION
701 Pennsylvania Avenue, N.W.
Fourth Floor - East Building
Washington, D.C. 20004
(202)508-5995

Interest in the acquisition of battery powered electric buses is also expected from school districts, many of which are also facing requirements to convert to the use of cleaner fuels. Other frequently identified potential applications for battery powered electric buses include on-off airport shuttles and transport vehicles used or educational and other institutional campuses.

Finally, the advancement of electric transportation technologies presents opportunities for U.S. technological innovation and worldwide leadership. In particular, the development and advancement of battery powered bus technologies offers significant opportunities for the defense and aerospace industries heavily impacted by reductions in defense spending.

Recognition of these and other benefits of electric transportation led to the inclusion of tax benefits for electric vehicles in Title XIX of the Energy Policy Act of 1992. New Section 30 of the Code, providing an income tax credit of 10 percent of the cost of a qualified electric vehicle, capped at a maximum credit of $4,000, is perhaps the most significant incentive now available to encourage the introduction of this environmentally superior transportation mode.

The Energy Policy Act also created a tax deduction in Section 179A of the Code for vehicles powered by clean fuels other than electricity. The amount of the deduction for clean fuel vehicles other than electric is graduated, based on the weight of the vehicle. However, the definition of a "qualified electric vehicle" entitled to the Section 30 income tax credit *does not reflect differences in vehicle weight or use*. As a result, no matter what the cost, or vehicle weight or use, of an electric vehicle, the amount of the tax benefit under Section 30 is limited to a maximum $4,000 tax credit.

Under the deduction available for qualified clean fuel property in Section 179A of the Code, the purchaser of a truck or van with a gross vehicle weight rating greater than 26,000 pounds -- *or any bus which has a seating capacity of at least 20 adults* -- is entitled to an income tax deduction of $50,000, compared to the $4000 maximum income tax credit available to electrics.

The difference in the value of the tax benefit available to the purchaser of a bus entitled to the clean fuel vehicle deduction versus an electric bus is several thousands of dollars. The Coalition does not believe that the disparity between benefit to heavy duty EVs and electric buses as compared to other clean fuel buses and heavy duty vehicles was intended by Congress. While the EV tax credit provides an important incentive for light duty electric vehicles, the value of the benefit is far less for more costly heavy duty electric vehicles and battery powered buses.

Because of their substantial cost -- attributable in part to the new technologies involved -- a tax incentive to encourage production and purchase of electric buses is vital to assure a successful commercial launch and development of a sustainable market. Present law does not provide an effective incentive.

Electric buses and heavy duty vehicles should be entitled to similar tax treatment as other clean fuel buses and heavy duty vehicles.

Congress has an opportunity to correct this situation and "level the playing field" among various heavy duty clean fuel modes. We urge the Committee to support the amendment proposed to Section 179A as included in H.R. 2026.

This letter is submitted on behalf of the Electric Transportation Coalition for inclusion in the record of the Committee's hearing held on June 24, 1993. Thank you for your consideration of this matter.

Sincerely,

Kateri A. Callahan

Kateri A. Callahan
Executive Director

ELECTRIC TRANSPORTATION COALITION

MEMBERSHIP

June 22, 1993

Allegheny Power Service Corporation
American Electric Power Service Corporation
American Nuclear Energy Council
American Public Power Association
Arizona Public Service Company
Asea Brown Boveri, Inc.
Baltimore Gas & Electric Company
Boston Edison Company
California Department of Commerce
Centerior Energy Corporation
Chattanooga Area Regional Transportation Authority
Chrysler Corporation
City of Albuquerque
City of Chicago Department of Environment
City of Detroit
City of Riverside
City of San Diego
Commonwealth Edison
Consolidated Edison of New York
Consumers Power
Copper Development Association
Detroit Edison
District of Columbia Energy Office
Duke Power Company
Edison Electric Institute
El Paso Electric Company
Electricar
Electrosource, Inc.
Entergy Corporation
Florida Power and Light Company
Florida Power Corporation
Florida Solar Energy Center
FMC Corporation
Ford Motor Company
General Motors Corporation
General Public Utilities
Georgia Tech Research Institute
Hughes Aircraft Company
Illinois Power Company
International Brotherhood of Electrical Workers
International Lead Zinc Research Organization
Kansas Electric Utilities Research Program
Long Island Lighting Company
Los Angeles Department of Water & Power
National Electrical Manufacturers Association
National Rural Electric Cooperative Association
Nevada Power Company
New York City Department of Telecommunications & Energy
New York Power Authority
New York State Electric and Gas Corporation
Niagara Mohawk Power Corporation
Northeast Utilities

Northern Indiana Public Service Company
Oklahoma Gas & Electric Company
PacifiCorp
Pacific Gas & Electric Company
Pennsylvania Energy Office
Pennsylvania Power & Light Company
Philadelphia Electric Company
Potomac Electric Power Company
PSA Peugeot-Citroen/USTR
PSI Energy
Public Service Electric & Gas Company
Sacramento Municipal Utility District
Salt River Project
San Diego Gas & Electric Company
Solar Energy Industries Association
South Carolina Electric & Gas Compan
Southern California Edison
State of Colorado
State of Hawaii/HTDC
Texas A&M University System
The Doe Run Company
The Southern Company
Theodore Barry & Associates
Town Creek Industries, Inc.
Unique Mobility, Inc.
University of California, Davis
University of South Florida
Villanova University
Virginia Power
West Virginia University

INDEPENDENT PETROLEUM ASSOCIATION OF AMERICA

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June 28, 1993

The Honorable Charles Rangel
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
Washington, D.C. 20515

re: H.R. 2026, Renewable and Energy
Efficiency Incentives Act of 1993

Dear Mr. Chairman:

By this letter, the Independent Petroleum Association of America (IPAA) is providing its views in opposition to H.R. 2026, Renewable and Energy Efficiency Incentives Act of 1993. I request that this letter be made part of the record on H.R. 2026.

Two provisions of H.R. 2026 are the basis of IPAA's opposition -- Section 305 and Section 306. These two sections have virtually no impact on multinational oil companies; their detrimental impact, which is severe, falls squarely on the independent section of the domestic oil and natural gas industry and most particularly on marginal well producers.

Section 305 would limit the deduction for percentage depletion for oil and natural gas wells to adjusted basis.

Enactment of Section 305 would destroy the long-standing and eminently logical distinction in tax law between depreciating assets (buildings, vehicles, machine tools, etc.) and depleting assets (oil and natural gas reserves, minerals, etc.) and would undermine an important element of the capital structure which, quite frankly. barely sustains the domestic independent oil and natural gas industry today. As depleting assets, oil and natural gas must provide, through sales of production, capital recovery sufficient to maintain the business enterprise and to fund the rising costs and risks of reserve replacement. For depleting assets, the capital asset itself is exhausted through its beneficial economic use. Unlike depreciating assets, oil and natural gas assets, once depleted, have no significant resale or salvage potential. Furthermore, new reserves are generally more costly and have higher risks than the costs and risks of the depleted reserves they replace.

The geological risks of finding and developing new oil and natural gas reserves are extraordinary compared to risks most other businesses face. Even where technological advancements have decreased the risks of reserve replacement (computerized 3-D seismic, for instance), those advancements have come with substantial increases in up-front capital costs. Price uncertainty for crude oil and natural gas compounds the geological risks of domestic oil and natural gas reserve replacement, while the failure to replace reserves means nothing less than liquidation for most domestic independent oil and natural gas producers.

Section 305 would take the tax code in the wrong direction on percentage depletion, which should be expanded rather than restricted. In response to the statement of Assistant Treasury Secretary Leslie Samuels on H.R. 1024, the IPAA testified on June 24, 1993, regarding the recent increase of percentage depletion for marginal properties (stripper wells) made in recent tax legislation:

> *"While stripper wells are eligible for percentage depletion rate of 19 percent, due to the net income limitation the tax benefit to producers can be eliminated altogether and, on average, produces a percentage depletion rate as low as 2 percent. In other words, because most stripper wells are operated at a loss or generate very little income, they are denied the tax deductions properly allowed to other oil and gas properties, principally because of the net income limitation.*
>
> *"To the extent that the net income limitation denies substantial regular tax benefit to independent producers from percentage depletion, the recent elimination of the AMT preference is practically inconsequential. At the time the changes were made in percentage depletion for marginal wells, IPAA urged Congress to also repeal the net income limitation to make those changes effectual. The repeal of the net income limitation is sorely needed to give meaning to previous congressional action and, as for as maintaining and enhancing existing production is concerned, is one of the most important aspects of H.R. 1024."*

Section 305 of H.R. 2026 is counter-productive fostering an increased reliance on domestic energy resources, a principal objective of the Energy Policy Act of 1992. Section 305 is opposed by several organizations that support the bill's tax incentives for renewable energy resources.

Section 306 repeals the exception from passive loss limitation for working interests in oil and natural gas properties.

The IPAA also opposes Section 306 of H.R. 2026. This provision virtually eliminates a primary source of investment capital for domestic oil and natural gas exploration and development -- other oil and natural gas producers!

The vast majority of investment in domestic drilling comes from independent producers' internally generated funds. According to a recent survey of IPAA members, the source of 55 percent of drilling capital is internal funds. That is not surprising, considering the relative risks of drilling investments. Moreover, greater than one in five dollars invested in new drilling comes from other oil and gas producers, who share the costs and the risks of development as working interest owners. Banks provide only nine percent of drilling capital to the industry.

Eliminating working interest investment capital, as proposed in Section 306, would reduce substantially the already anemic capital investment in drilling that has forced the rotary rig count to its lowest levels since record keeping began and has resulted in the loss of hundreds of thousands of oil and natural gas producing jobs throughout the country.

The compelling economic factors which led Congress in 1986 to provide a working interest rule for the oil and natural gas industry still exist today. Moreover, the working interest rule is not a wholesale exception from the material participation standard; it is restricted to investors who accept an unlimited and unprotected financial risk proportionate to their ownership interest in oil and natural gas activities. Indeed, the working interest rule has a great deal in common with other exceptions to the material participation rule, none of which perpetuate the types of tax shelters deductions which the Congress sought to eliminate in the Tax Reform Act of 1986 with the passive loss rules.

Thank you, Mr. Chairman, for considering these views. If I may provide additional information or respond to any questions regarding these comments or other matters affecting the domestic independent oil and natural gas industry, please call on me at 202-857-4731.

Sincerely,

Roy W. Willis

ROY W. WILLIS
Vice President for
Government Relations

cc: subcommittee members
IPAA distribution list

STATEMENT OF
THE CITY OF LOS ANGELES
ON HR 2026
SUBMITTED TO THE
COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MATTERS
June 24, 1993

The City of Los Angeles (City) supports the goals of HR 2026 by Congressman McDermott to stimulate the development of renewable energy resources but is adamantly opposed to section 302, a direct assault on the discretion of state and local governments to issue tax-exempt bonds for municipal purposes.

The City's Department of Water and Power (DWP) is the largest municipal utility in the United States and serves the 3.5 million residents of Los Angeles. The DWP has been a leader in environmentally responsive energy projects and programs including demand-side management, conversion from petroleum to electricity-based transportation modes, energy efficiency improvements, and development of renewable energy resources. The DWP is either operating, constructing, or developing projects that cover the gamut of renewable resources including, solar, geothermal, wind, and hydro. Further, the DWP has committed to meeting Los Angeles' increased electricity needs through 2000 (estimated to be 600 megawatts) through a combination of increased conservation and renewable energy resources.

Therefore, the City shares Congressman McDermott's enthusiasm for renewables, even though all the benefits of this legislation accrue to investor-owned utilities (IOUs) with none provided to municipally-owned utilities. But we cannot comprehend the logic of eliminating the tax-exempt bonding authority of municipal utilities to construct coal (for example) facilities in order to provide direct tax benefits to investor-owned utilities (IOUs) to construct renewables while retaining the tax benefits for IOUs to continue to build identical coal facilities. This is especially out of balance in light of the fact that the vast majority of coal, oil, and nuclear electricity generating facilities (targeted as undesirable by HR 2026) are owned by IOUs. A much more balanced approach would be to eliminate the IOU tax benefits to construct the non-favored fueled facilities in order to offset the revenue required to provide the new tax benefits for IOU construction of renewable projects.

The most troubling aspect of section 302, however, is the encroachment of Congress on decisions that more appropriately and historically have been the discretion of state and local governments. Traditionally, decisions as to what facilities are financed by tax-exempt bonds have been the decisions of state and local governments, so long as the facilities are owned and operated by government and the benefits of those facilities are available to all citizens. Section 302 opens the door to tampering with state and local tax-exempt bonding discretion on a broad range of municipal facilities by the federal government in order to force "correct" decisions .

In conclusion, the City supports incentives for renewable energy projects but opposes the elimination of municipal tax-exempt bonding authority to finance those incentives.

STATEMENT FOR THE HEARING RECORD OF THE NATURAL RESOURCES DEFENSE COUNCIL IN SUPPORT OF H.R. 2026 & H.R. 784

Submitted to the Subcommittee on Select Revenues
U.S. House of Representatives
June 24, 1993

The Natural Resources Defense Council (NRDC) is a national, non-profit environmental protection organization with 180,000 members nationwide. NRDC has been involved in energy and environmental issues for over two decades at all levels of government.

NRDC strongly supports legislation introduced by Congressman Jim McDermott to reform federal tax policy in ways that will move the United States toward an economically competitive and environmentally sustainable energy future.

In times of constrained public resources and mounting concern over such environmental hazards as poor air quality and potential climate change, it is high time for tax reform that shifts government support from polluting and non-renewable sources of energy to clean, renewable alternatives and energy efficiency. H.R. 2026, the "Renewables and Energy Efficiency Incentives Act of 1993", takes an important step in this direction.

Existing federal subsidies to the energy sector are conservatively estimated at a market value of $36 billion according to a recent study issued by the Alliance to Save Energy. Of the subsidies provided throughout the tax code, 85-90% benefit conventional fuels -- such as oil, coal, and nuclear -- while only 15% benefit energy efficiency and emerging renewable resources. Thus, most existing subsidies benefit fuels that are not only mature and well-developed, but also contribute to global warming and air pollution, create long-term hazardous waste problems, and foster continued dependence on foreign sources of energy with attendant risks to our domestic economic security. This imbalance must be addressed if the U.S. is to make the transition to an environmentally and economically healthy energy economy.

First, Congress should remove or reduce unjustified subsidies to established, polluting energy resources. This includes subsidies to fuels -- such as ethanol from corn -- that may be touted as "clean" and "renewable" but that have negative environmental impacts comparable to (or even greater than) conventional fuels when evaluated on a full fuel-cycle basis, as well as subsidies to the coal, petroleum, and nuclear industries. Specifically, NRDC supports provisions in H.R. 2026 that reduce tax subsidies to ethanol; repeal subsidies for coal, oil, or nuclear powered electricity generating facilities; limit percentage depletion deductions for oil and gas wells; and repeal exceptions from passive loss limitations for oil and gas properties.

At the same time, Congress should provide positive incentives to spur the development and commercialization of emerging clean, domestic resources, including energy efficiency and renewable technologies such as wind and solar power. These technologies have the potential to significantly reduce environmental hazards and protect the U.S. economy from volatile foreign energy markets -- and are likely to provide a valuable export product in future global markets for clean energy technologies. NRDC specifically supports the provisions in H.R. 2026 thatallow emerging renewable energy industries to benefit from energy credits. NRDC also supports full exclusion from taxable income for energy conservation incentives provided by utilities for efficiency improvements to non-residential property (a partial exclusion was included in the Energy Policy Act of 1992).

Finally, NRDC specifically endorses the provision in H.R. 2026 -- which is also separately contained in H.R. 784 -- that clarifies and affirms longstanding IRS policy toward utility expenditures for energy efficiency programs. H.R. 2026 and H.R. 784 would explicitly allow utilities to deduct energy efficiency expenditures for tax purposes in the year they are incurred. Without this clarification, threatened changes in IRS policy that would force utilities to spread conservation deductions over several years could seriously undermine utilities' growing commitments to energy efficiency around the nation. One utility has estimated that its annual conservation expenditures would be reduced by as much as 10% if these expenses must be capitalized. Such a dampening effect on efficiency programs would result in substantial lost opportunities to reduce overall energy costs to households and businesses, improve economic competitiveness, and mitigate the risk of climate change.

In conclusion, tax policies have too long perpetuated a risky reliance on depletable and polluting energy resources. Rather than fostering the development of clean, domestic alternatives tax policy has impeded it by bolstering the market advantage enjoyed by mature energy industries. Congress should pass H.R. 2026 in the interests of a sustainable, environmentally sound and economically competitive energy future. Sensible tax policy should enlist market forces in effecting this transition, not stand in the way.

TESTIMONY OF MARK BONSALL
LARGE PUBLIC POWER COUNCIL

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to submit this testimony on H.R. 2026, the Renewables and Energy Efficiency Incentives Act of 1993. My name is Mark Bonsall, and I serve as the Associate General Manager for Financial, Information and Planning Services of the Salt River Project of Phoenix, Arizona. SRP is the third largest public power company in the United States and the largest water supplier in the state of Arizona. I am pleased to submit this testimony on behalf of the Task and Finance Task Force of the Large Public Power Council (LPPC). LPPC is comprised of the eighteen largest public power systems in the nation. Although these companies are geographically and operationally diverse, they are all municipal entities owned by and accountable to the customers they serve.

The LPPC opposes that provision (Section 302) of the legislation prohibiting the use of tax-exempt financing for the construction of nuclear and fossil fuel power plants. Although LPPC strongly supports the development of renewable energy sources, we strongly object to the bill's proposed restriction on the issuance of tax exempt debt; we believe that such a restriction would have an extremely deleterious effect on utilities and ratepayers throughout the country.

The practical effect of H.R. 2026 would be to provide preferential treatment to investor-owned utilities at the expense of public power utilities. Public power companies, which participate in a highly capital-intensive industry, have more limited access to various sources of capital than their investor-owned counterparts. We depend upon tax-exempt financing to fund our infrastructure improvements. As introduced, the bill would severely restrict our access to such financing in order to fund tax incentives for the development of renewable energy resources. Only investor-owned utilities, however, would benefit from those incentives. As a consequence, the bill provides investor-owned utilities all of the "carrots", while thumping public power with the "sticks".

The negative and inflationary effects of this legislation would extend beyond the ratepayers of public power utilities. Both public and private power utilities requiring additional capacity regularly contract to purchase power from other utilities with excess generating capacity. For example, the generating capacity of hydro-dependent utilities in the Pacific Northwest has been depressed by drought conditions over the past year. Consequently, these utilities have increased bulk power purchases from utilities in the southwestern United States. Much of the purchased energy is generated by nuclear and coal-fired plants, financed in part by tax-exempt debt. Contractual terms of the sales and rates ultimately charged to customers reflect the benefits of tax-exempt financing. Accordingly, the preclusion of tax-exempt financing for construction of nuclear and coal-fired facilities would increase rates for customers of public and private utilities throughout the country. Given generating constraints throughout different regions of the country, inter-regional power purchases are expected to continue at higher than normal levels over the next several years.

LPPC members are proud of their continued efforts to reduce the environmental impacts of their operations. For example, Western utilities -- which are necessarily reliant on coal, nuclear-fired, and hydro generation -- have been notably aggressive in the development and implementation of environmental mitigation measures. The West, one of the cleanest regions of the country, is further regulated by strict environmental standards. Ratepayers in our service territories pay substantial premiums on their electric bills to assure clean air quality. We believe that any incremental environmental benefits of the pending legislation would be insufficient to justify the additional costs imposed upon our ratepayers or upon society at large.

In conclusion, we oppose the proposed legislation on the grounds that it is inequitable and will have deleterious and unintended consequences on ratepayers throughout the country.

Thank you again for the opportunity to submit this testimony.

Statement of
the Southern California Public Power Authority
on H.R. 2026
the Renewables and Energy Efficiency Incentives Act
Submitted to the
Subcommittee on Select Revenue Measures
July 9, 1993

The Southern California Public Power Authority (SCPPA) appreciates the opportunity to submit this statement on H.R. 2026, the Renewables and Energy Efficiency Incentives Act, sponsored by Rep. Jim McDermott (D-WA).

SCPPA is a joint action agency formed in 1980 to maximize the resources of its 11 members and to support their common goal of providing customers with reliable, cost-efficient electrical generation and supply. SCPPA members include the municipalities of Anaheim, Azusa, Banning, Burbank, Colton, Glendale, Los Angeles, Pasadena, Riverside, Vernon and the Imperial Irrigation District. To date, SCPPA has issued over $6.4 billion in tax-exempt bonds to finance and build electric generation and transmission facilities.

SCPPA supports the overall objectives of H.R. 2026 -- to provide incentives for greater use of renewable energy resources and energy efficiency measures. A number of SCPPA member utilities have aggressive energy conservation and efficiency programs, and several are developing renewable energy projects that include wind, solar, geothermal and biomass resources. SCPPA members have also been actively involved in legislative and regulatory activities to implement the Renewable Energy Production Incentive program authorized in last year's Energy Policy Act. That program would provide incentive payments for energy generated at qualified renewable energy facilities owned by municipal or rural electric cooperative utilities. It is the counterpart to an investment tax credit authorized in the Act for similar facilities developed by investor-owned utilities.

However, SCPPA objects strongly to section 302 of H.R. 2026. That section would eliminate the use of tax-exempt financing for the construction of new coal, oil or nuclear powerplants. Due to ambiguities in the language, section 302 may also preclude the use of tax-exempt bonds to refurbish or refinance existing powerplants that use those fuels and/or to build dual-fuel coal and gas-fired facilities.

Municipal electric utilities are units of state and local government and, as such, are entitled to issue tax-exempt bonds for facilities owned and operated by the governmental entity, the benefits of which are provided to all its citizens. Section 302 would usurp the authority of state and local governments to make decisions about the type of energy facilities needed to meet electricity demand and would effectively put the federal government in the role of choosing which energy sources are appropriate for communities served by public power systems. SCPPA believes that legislating this type of federal intrusion into state and local financing decisions is inappropriate and unwise.

H.R. 2026 purports to "level the playing field" for renewable energy resources vis-a-vis conventional fuels. In fact, however, the bill radically distorts the utility industry playing field by targeting only one segment of the electric utility industry: public power systems. H.R. 2026 does nothing to limit future investments by investor-owned utilities in coal, oil or nuclear power facilities or to eliminate tax benefits related to those facilities that private utilities now claim.

H.R. 2026 is also skewed on the incentives side. Although no new tax benefits flow to public power systems under the bill, investor-owned utilities are granted additional tax deductions for investments in demand-side management programs incurred or paid over the last 13 years. In SCPPA's view, this disparity in treatment between public and private power is unfair and alters the competitive balance in the U.S. utility industry.

SCPPA supports making federal incentives for renewable energy and energy efficiency measures available to all types of electric utilities but urges the Subcommittee to delete section 302 from H.R. 2026.

* * * *

SCPPA would also like to take this opportunity to express its support for H.R. 1938, legislation sponsored by Rep. Richard Neal (D-MA) that would eliminate the special $15 million "private use" limitation that applies only to public power bonds used to finance output facilities. SCPPA is aware of no fiscal or policy reason for imposing the additional private use restriction on public power bonds. However, the artificial $15 million private use cap creates significant financing difficulties and promotes inefficiencies for SCPPA and other municipal electric entities around the country.

SCPPA is pleased to note that the Treasury Department testified that it sees no justification for the special limitation and does not oppose the Neal bill. We hope this Committee will act promptly to remove the $15 million private use restrict and allow greater flexibility in financing future public power output facilities.

Statement of Robert T. Boyd
Director of Regulatory Affairs
KENETECH/U.S. Windpower

Submitted to the Subcommittee on Select Revenue Measures
Committee on Ways and Means

June 24, 1993

The foregoing comments are submitted on behalf of KENETECH/U.S. Windpower, a fully integrated manufacturer of wind turbines and a developer, constructor and operator of wind powered electrical generation plants. KENETECH/U.S. Windpower is the largest such company in the world. The Company is headquartered at 500 Sansome Street, Suite 800, San Francisco, California 94111, telephone (415) 398-3825.

KENETECH/U.S. Windpower urges: 1) the adoption of alternative minimum tax relief which would allow the use of the section 45 production tax incentive granted in the Energy Policy Act of 1992 against the alternative minimum tax, 2) modification of section 45 rules to permit leasing and 3) clarification of section 45 as to the qualification of projects under an operations contract.

The statement of the American Wind Energy Association (AWEA) deals effectively with items 1) and 3) and KENETECH/U.S. Windpower supports their comments. However, AWEA does not deal with lease transactions and we will address our comments to that specific area.

Leased Equipment Qualifications for Section 45 Production Credit

Summary: Section 45 prohibition of lease transactions prevents wind projects from being financed by leasing.

1. This is contrary to the energy regulatory provisions of the Energy Policy Act of 1992 which permit lease financing of exempt wholesale generators and independent power producers.

2. This is also contrary to the section 29 credit precedent which Congress used to model the section 45 credit.

Discussion:

Existing section 45 requires that a taxpayer own the wind or biomass generation facility to qualify the electricity generated for the production credit. This requirement prevents a utility or an energy company from leasing the generating equipment under a straight lease arrangement or under a lease-purchase arrangement.

Leasing and lease-purchase of capital equipment are regular business practices. Both arrangements reduce the up-front capital needed; leasing also shifts many of the investment risks from the lessee to the lessor. Leasing is common in the utility area. This practice has been spurred by public utility commission denial of adequate rates to cover utility investments in risky generation facilities.

A typical lease financing arrangement involves a passive investor who leases the facilities to a public utility company, an exempt wholesale generator (EWG) or an independent power producer (IPP). In view of the importance of leasing for the independent power sector, the Federal Energy Regulatory Commission recently modified its rules to allow leasing of EWG facilities under the Public Utility Company Act (PUHCA). Reversing its previous ruling in InterAmerican Energy Leasing Co., the commission held that the lease of a facility was equivalent to the sale of electric energy at wholesale for purposes of section 32(a)(1) of PUHCA so as to grant the facility's owner-lessor EWG status. The commission said that its prior ruling would have had "the unintended consequence of discouraging development of EWGs as contemplated by Congress" in the Energy Policy Act of 1992. See Federal Energy Regulatory Commission Order No. 550-A, 58 Federal Register 21250 (April 20, 1993).

The non-tax, energy provision of the 1992 legislation thus was interpreted to permit lease financing of electric cogeneration projects, but the tax provisions of the same legislation in section 45 still precludes leasing. The tax provision thus frustrates the development of exempt wholesale generators and independent power producers under the Energy Policy Act of 1993; moreover, it also contradicts the very precedent which the tax committees intended to follow in drafting section 45.

The section 45 wind and biomass production credit as originally proposed was intended to track the section 29 credit for nonconventional oil and gas production. Section 29 allowed lease transactions to qualify. Additional precedent can also be found under the pre-1986 investment tax credit. The lessor-owner under prior law section 48(d) could elect to pass through the investment credit to the lessee-operator. In line with these other code provisions, it is proposed that the production credit be allowed whether owns a leases the generation equipment.

It is our understanding that extending the production credit to the lessor-owner in a lease transaction raises some concern because of the appearance this gives of re-opening safe-harbor leasing. Allowing only the lessee-operator to claim the production credit in a lease arrangement is not as flexible as allowing either party to utilize the credit. However, even a partial lifting of the present absolute ban on leasing under section 45 would offer a limited measure of flexibility. Current law rules out all leasing transactions, because neither the lessor-owner nor the lessee-operator is eligible for the production credit. KENETECH/U.S. Windpower strongly recommends adoption of this proposal to permit leasing and lease-purchase financing of wind electric generation facilities.

TESTIMONY OF USX CORPORATION

PARTIAL OFFSET OF TENTATIVE MINIMUM TAX WITH NONCONVENTIONAL FUELS PRODUCTION CREDIT (SEC. 29)

This statement is submitted on behalf of USX Corporation, its subsidiaries, and the many domestic energy producers who qualify for the Section 29 Nonconventional Fuels Production Credits and are currently in an Alternative Minimum Tax (AMT) position. USX Corporation is a major worldwide producer of energy -- oil and gas. It is also one of the country's leading integrated producers of steel products.

We sincerely appreciate the attention the Committee has devoted to reforming the AMT generally, and are pleased that some relief for AMT taxpayers appears likely to be included in the 1993 Omnibus Budget Reconciliation Act. The purpose of this testimony, however, is to highlight a problem unique to the class of AMT taxpayers that qualify for Section 29 credits, but are unable to take advantage of the credits at the time they are most needed and would be most beneficial for energy conservation and the economy at-large.

Background

The Section 29 credit for producing fuel from a nonconventional source was established to encourage and help make economical the development of nonconventional domestic energy sources. The fuels that qualify for the production credit include oil from shale and tar sands, gas from geopressured brine, Devonian shale, coal seams, tight formations, or biomass, synthetic fuels from coal, as well as other nonconventional fuels. Under current law, these fuels are eligible for an income tax credit equal to $3.00 per barrel (generally adjusted for inflation) or Btu oil barrel equivalent.

Discussion

Presently, Section 29 credits may be applied to a taxpayer's regular income tax liability. The credit may not exceed the excess, if any, of the regular tax over the tentative minimum tax. As a result, a taxpayer that pays alternative minimum tax receives no current credit. Credits that cannot be used because of this limitation may be carried over to future years as part of the minimum tax credit, which may be used against regular tax liability.

Unfortunately, many of the producers of qualified nonconventional fuels are expected to be alternative minimum taxpayers indefinitely or at least for several years. These taxpayers will either lose the credit entirely if they remain in the AMT or receive a credit in the distant future that is significantly diminished in value.

The examples below illustrate the unfair situation created for AMT taxpayers:

	(Regular) Taxpayer 1	*(AMT)* Taxpayer 2
Qualified Sec. 29 Credits	60	60
Regular Income Tax Liability	200	70
Tentative Minimum Tax Liability	70	200
Total Tax Liability before Credits	200	200
Value of Sec. 29 Tax Credit in Current Year	60	0
Net Tax Liability in Current Year	140	200

Existing tax law is effectively encouraging the use of various investment mechanisms and elaborate tax motivated transactions in order to take advantage of the credits. These arrangements have the effect of shifting the credits away from producers of nonconventional fuels to those having little stake in the actual development of the energy resource.

Recommendation

We urge the Committee to allow AMT taxpayers earning Section 29 credits for nonconventional fuels to offset up to 25% of their tentative minimum tax liability. Such a change would reduce the inequity between taxpayers paying regular tax and obtaining the benefit of nonconventional fuels credits and taxpayers incurring an AMT liability and receiving no immediate benefit from the nonconventional fuels credit. Credits that were not used to offset 25 percent of tentative minimum tax would continue to be eligible to be carried over to future years as part of the minimum tax credit. An example of how this proposal would effect the AMT taxpayer in the year the credit is earned is illustrated below:

	(Regular) Taxpayer 1	*(AMT)* Taxpayer 2
Qualified Sec. 29 Credits	60	60
Regular Income Tax Liability	200	70
Tentative Minimum Tax Liability	70	200
Total Tax Liability before Credits	200	200
Value of Sec. 29 Tax Credit in Current Year	60	50
Net Tax Liability in Current Year	140	150

Conclusion

Allowing a partial offset against tentative minimum tax for taxpayers who actually earn the Section 29 credit would serve as an incentive for the production of nonconventional fuels, encouraging the development of domestic energy sources involving new technologies and reducing the need for imported energy. In addition to rewarding investment in America's energy independence, such a change in the tax code also would contribute to tax fairness and economic efficiency.

Washington Citizens for WORLD TRADE

Statement of
Washington Citizens for World Trade
submitted to the
Subcommittee on Select Revenue Measures
of the
House Committee on Ways and Means
June 24, 1993

The Honorable Chairman and members of the subcommittee:

Thank you for this opportunity to submit the views of Washington Citizens for World Trade on H.R. 960 (by Reps. Kopetski and Wyden) and H.R. 1997 (by Rep. DeFazio), legislation to eliminate certain tax benefits for log exports and to provide other tax incentives for reforestation and timber production.

Washington Citizens for World Trade is a forest products trade association based in Olympia, Washington. WCWT's members include integrated forest products companies, non-industrial tree farmers, ports, unions, stevedores, and others supportive of unrestricted markets for forest products, including logs.

WCWT seeks to make three main points regarding the legislation before this subcommittee:

1. WCWT opposes the elimination of the foreign sales corporation tax provision and other favorable tax provisions for log exports that are available to exporters of other commodities;
2. If tax benefits for log exports are eliminated, the revenue savings should be applied to reforestation and timber production rather than general revenues; and
3. WCWT strongly opposes any proposals to ban, tax, or otherwise restrict the export of logs from private property.

First, elimination of the foreign sales corporation and other tax benefits for log exports unfairly discriminates against producers of a privately grown commodity -- an unsettling precedent for producers of other commodities. Elimination of these tax benefits won't solve or mitigate any of the problems caused by reductions in public timber sales. If elimination of these tax benefits reduces log exports as intended, it will also reduce export-related employment. The only certain impact of the elimination of these tax benefits is that it will reduce revenues needed by tree farmers for reinvestment in private forestry.

Second, if tax benefits are eliminated for log exports, the revenue saved should be reinvested in reforestation and timber production. With severe reductions in public timber sales and increasing environmental restrictions on public and private timber harvesting, private timber reforestation and production are vital for our future timber supply and economic health. Both H.R. 960 and H.R. 1997 contain tax incentives for reforestation and timber production, although H.R. 960 is preferable because it provides these incentives for all privately grown timber, regardless of where it is processed.

WCWT asks the subcommittee to oppose and defeat proposals to eliminate tax benefits for log exports that do not contain incentives for reforestation and timber production. Accordingly, WCWT asks the subcommittee to support efforts in conference to remove Senator Baucus' (D-Mont.) log export provisions in the Senate version of the Budget Reconciliation Act. Senator Baucus included provisions to eliminate the FSC and other tax benefits for log exports in the Senate version of the reconciliation bill, but failed to include any incentives for reforestation or timber production. This issue is better addressed in the legislation currently before this subcommittee.

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Finally, WCWT asks the committee to support the efforts of Congressman Kopetski and others to oppose any proposals to ban, tax, or otherwise restrict log exports from private property. Congressman Kopetski understands that log exports from private property have not caused the public timber crisis in the Pacific Northwest and restrictions on private log exports will not solve those problems. In Congressman Kopetski's home state, public timber sales volumes have been reduced by 4 billion board feet annually and private log exports only amount to 250 million board feet. While restrictions on private log exports will not solve any problems, such restrictions would hurt private tree farmers, undermine international trade negotiations and U.S. trade policy, eliminate thousands of jobs, and jeopardize U.S. agricultural trade.

Thank you for considering the views of Washington Citizens for World Trade.

Submitted on behalf of

WASHINGTON CITIZENS FOR WORLD TRADE

By: Nicholas J. Kirkmire
Executive Director

APPA

National Rural Electric
Cooperative Association

June 30, 1993

The Honorable Charles Rangel
Subcommittee on Select Revenue Measures
1105 Longworth House Office Building
Washington, DC 20515

Dear Chairman Rangel:

The American Public Power Association (APPA), the National Rural Electric Cooperative Association (NRECA) and the National Association of Regulatory Utility Commissioners (NARUC) support amending Section 1912 of the Energy Policy Act of 1992 (EPAC) to make all residential utility rebate payments to customers non-taxable beginning July 1, 1989. Testimony on this provision was presented to your Subcommittee on Thursday, June 24, during consideration of the Natural Resources section of the Miscellaneous Revenue Issues.

APPA, NRECA and NARUC believe this provision fills a legislative gap and addresses an inequity that arose when a similar provision in energy law expired. That inequity persisted until Congress enacted the EPAC, which, among its many provisions, made conservation rebates for residential utility customers non-taxable beginning in 1993.

To provide consistent treatment to ratepayers and to reinforce consumer confidence in utility rebate programs, the provision should be effective from July 1, 1989, the date of expiration of pertinent energy law, not from the beginning of 1993. Utility rebate programs are a proven way of achieving significant energy conservation savings and we believe that this change will reinforce the intent of Section 1912 of the Energy Policy Act.

Sincerely,

Larry Hobart
Executive Director
American Public Power Association

Bob Bergland
General Manager
National Rural Electric Cooperative Association

Thomas Choman
Director, Congressional Public Relations
National Association of Regulatory Utility Commissioners

SACRAMENTO MUNICIPAL UTILITY DISTRICT
IN SUPPORT OF AN AMENDMENT TO THE ENERGY POLICY ACT OF 1992 TO ELIMINATE THE TAXABLE STATUS OF UTILITY REBATES RETROACTIVE TO COVER THE PERIOD JULY 1, 1989 TO DECEMBER 31, 1992

During the 1990's, energy utilities across the United States have invested hundreds of millions of dollars in energy efficiency. These utilities and state utility commissions have recognized the clear economic, environmental, and national security benefits to consumers and society of energy efficiency in comparison to power production.

No issue has had a more negative impact on the District's energy efficiency programs than has the taxability of utility rebates. There is no question that many residential customers have been "turned off" to making cost effective efficiency improvements due to the IRS tax liability of utility efficiency rebates. It has been particularly difficult for customers to understand the logic of considering manufacturer rebates for appliances non-taxable while rebates paid to them for improving the efficiency of their appliances and homes have been called taxable. It has been very frustrating to face a disincentive of a federal tax while at the same time manufacturer's appliance rebates remained tax free. Taxing customers who invest in energy efficiency seems contrary to the best interests of all parties involved.

When the Energy Policy Act was passed in October 1992, it eliminated a major problem for utility energy efficiency programs across the nation. The Act excluded from taxable income the value of any subsidy provided by a public utility to a residential customer for the purchase and/or installation of an energy conservation measure, for taxable years beginning after 1992. This change removed a significant barrier for those customers desiring to make energy efficiency improvements, and an onerous tax requirement placed on those customers who will be making a decision to invest in energy efficiency for the future. While the Act provided a satisfactory resolution to this problem for 1993 and beyond, it did nothing to resolve the issue for thousands of residential customers who had already been unfairly burdened with an unreasonable tax requirement in previous years.

The Sacramento Municipal Utility District supports amending Section 1912 of the Energy Policy Act of 1992 to make all residential utility rebate payments made to customers non-taxable retroactive to July 1, 1989. We believe that while the number of customers involved and the amount of tax dollars to be refunded is potentially significant, in reality, this action will not have a significant impact on federal revenue due to few taxpayers applying for refunds and fewer utility rebates during 1989 to 1993. In most cases, utility rebate programs were just beginning to ramp up during the time period from July 1, 1989 to December 31, 1992. The following information about the District's own rebate programs is provided as an illustration of the number of customers impacted by this action and the amount of rebate dollars involved.

The District did not begin providing meaningful level of rebates until 1989/1990. There were only a total of eleven (11) 1099's sent out to cover rebates paid out to individuals who had received $600 or greater (the required limit for submittal of a 1099) in rebates. The total amount paid in these cases was nearly $35,000. In addition, the District paid rebates totalling over $300,000 to another 2,000 plus customers to whom a 1099 was not sent because the individual dollar amounts did not exceed the $600 or greater limit.

For 1991, the District ended up sending out over four-hundred (400) 1099's totalling in excess of $800,000. We had over 25,000 additional residential customers who received individual rebates totalling less than $600. The total amount paid out to these customers was over $4.5 million.

For 1992, we sent out over three-thousand (3,000) 1099 forms to residential customers. These customers alone received over $6 million in rebate payments. In addition, we had over 27,000 taxpayers who received smaller rebate amounts which totalled nearly $3.5 million.

Defenders of allowing rebates to be taxed have argued that, when it came to energy efficiency, individual consumers and businesses should be left to respond to market forces. It has been well documented, however, that there are numerous market "barriers" which greatly limit investment in energy efficiency by consumers and businesses. These barriers include high upfront costs, lack of information, perceived risk of "new" technologies, unavailability of high-efficiency equipment, relatively long paybacks, institutional barriers, and consumer inertia. Over the past few years, the nation's energy utilities have made tremendous use of rebate programs to overcome these barriers. As noted previously, however, those concerned consumers who have chosen to support these programs have been penalized for their decision to participate.

While the Energy Policy Act has many positive benefits for energy efficiency programs, it provides no benefits for those customers who saw the need for making changes in 1989, 1990, 1991, and 1992. There is an inequity in the system when the date of an installation determines whether or not you will be rewarded or penalized for your decision. It is the position of the Sacramento Municipal Utility District that the only logical solution to this situation now is to take action which will retroactively make all energy utility rebates paid to residential customers in 1990, 1991, and 1992 non-taxable. The District supports and encourages the enactment of an amendment to the Energy Policy Act which will address this matter.

It is the District's expectation that most of the people impacted by this action will not take advantage of this opportunity if it is presented. From our programs alone, we would expect the potential level of refunds to be less than $100,000. The main issue is, therefore, not the financial impact this decision has had on people, but more the question of the inequity that existed in the way they were treated. We believe this proposed action is as much a gesture of providing equity for all taxpayers, as it is a matter of giving them back money.

TESTIMONY OF WILLIAM E. PERESSINI
PACIFICORP FINANCIAL SERVICES

PacifiCorp Financial Services (PFS) appreciates the opportunity to present its views before this subcommittee on ways to improve the administration of the low-income housing credit program. PFS is an affiliate of PacifiCorp, a diversified electric utility company serving retail customers in Oregon, Utah, Wyoming, Montana, Idaho, Washington and California. Since 1988, PFS's Affordable Housing Group has been actively engaged in the acquisition and supervision of residential real estate properties for lower income individuals. PFS provides housing for over 2,800 low-income families in 14 developments across the country.

Our statement concerns six proposals that will simplify the administration of and compliance with the low-income housing credit program and better enable the credit program to accomplish its goal of making housing available to those who could not otherwise afford it. Four of the proposals have already been adopted by the Senate Finance Committee in its version of the budget reconciliation bill. We urge the subcommittee to adopt these proposals identified in the Subcommittee's June 2nd press release as items 11-16 under the "Housing" section, and work to have them included in the appropriate legislative vehicle. Attached is a revenue estimate of the proposals prepared by the Joint Committee on Taxation.

Related Low-Income Students Should Be Treated as Qualified Tenants under the Low-Income Housing Credit Rules

The legislative history of the low-income housing credit provides that the credit is not available for housing units occupied entirely by full-time students, none of whom is entitled to file a joint income tax return. This limitation was apparently intended to disqualify units used for housing groups of college students who would otherwise be considered "low-income" individuals. Unfortunately, the limitation defined "student" to include individuals attending not only graduate school and college but also grammar school, junior high school, and high school. Because of this definition, the limitation would prevent a low-income single parent attending school full-time and living with a child who is also attending school full-time from qualifying for low-income housing. This result discourages low-income parents from continuing their education and is contrary to public policy goals.

Congress attempted to address this inequity in the Omnibus Budget Reconciliation Act of 1990 when it amended the low-income housing credit to provide that a household is not disqualified if occupied by a student receiving federal assistance under the Aid to Families with Dependent Children ("AFDC") program. Although well-intentioned, this relief was too limited in scope to solve the problem since a single parent not receiving AFDC payments could still be disqualified from low-income housing if both the parent and child were full-time students -- even if the household met the low-income standard.

We urge this subcommittee to allow housing units occupied by single parents and their children to qualify for the low-income housing credit when the parent and child are both full-time students. In addition to eliminating the current law's disincentive for single parents to continue their education, this proposal would preserve the prohibition against groups of college students occupying space reserved for the truly needy.

This proposal was contained in H.R. 4210, the Tax Fairness and Economic Growth Act of 1992 and in the Senate version of H.R. 11, the Revenue Act of 1992. It was also introduced earlier this year by Senator Mitchell in S. 487. According to the Joint Committee on Taxation, this proposal would result in a de minimis revenue loss over fiscal years 1994-1998.

The Annual Recertification of Tenant Income Requirement Should be Eliminated for 100 Percent Low-Income Tenant Housing Developments

Under current law, each low-income tenant's income must be recertified annually to ensure that it falls within the statutory maximum income limit. Recertification requires landlords to obtain verification of tenant salary income from employers and tenant income from assets through such third parties as financial institutions, real estate agents and stockbrokers. Landlords must then project if the income to be earned from salary and assets will exceed the statutory limits. The recertification process is time-consuming, expensive, and administratively burdensome, and the process is discouraging and unnecessarily intrusive to existing and prospective qualified tenants.

If a tenant's income does not exceed 140 percent of the maximum income limit, the tenant may stay in the unit and the low-income property owner may continue to earn the low-income housing credit on the unit. If the tenant's income exceeds the 140 percent limit, the tenant may still remain in the unit; the owner may continue to earn tax credits on the unit only if the owner rents the next available unit to a qualified low-income tenant.

In the case of low-income housing developments that rent units only to qualified low-income tenants, in addition to being expensive, burdensome and intrusive, annual income recertification is also unnecessary. Landlords of such developments rent the next available unit to a qualified tenant regardless of the results of the recertification. Thus, in a 100 percent low-income tenant housing development, a recertification can never result in the denial of the low-income credit to the building or housing to the particular tenant, regardless of the determination of a particular tenant's income, since the next available unit will always be rented to a qualified low-income tenant.

We therefore ask this subcommittee to authorize the Treasury to waive the annual recertification requirement for 100 percent low-income housing developments in which landlords are already obligated to rent the next available unit to a qualified low-income tenant. This proposal would eliminate the substantial, costly and unnecessary administrative burdens created by the recertification process without affecting tax-credit eligibility.

This proposal was contained in H.R. 4210 and in the Senate version of H.R. 11. It was also introduced earlier this year by Senator Mitchell in S. 487. The Joint Committee on Taxation estimates that this proposal would result in a de minimis revenue loss over fiscal years 1994-1998.

The Penalties for Noncompliance Should Include De Minimis Relief

For a building to be eligible for the low-income housing tax credit, it must continually comply with the "minimum set-aside requirements," beginning generally not later than the close of the first year of the credit period for such buildings. Under the minimum set-aside requirements, at least 20 percent of the building units must be occupied by households with incomes at or below 50 percent of the area median income or, in the alternative, 40 percent of the building units must be occupied by households with incomes at or below 60 percent of the area median income. If the building at any time fails to meet the minimum set-aside requirements, the building could be declared ineligible for the credit for all years remaining in the 15-year compliance period provided under the rules. This could be true even if a building's failure to meet the minimum set-aside requirements is de minimis and due to a good faith error in the methodology used to compute rents or determine income. Since such errors may not be discovered for several years, the building owner may be unable to return the building to compliance retroactively and may lose the low-income housing tax credits as a result.

The possibility that a building could completely lose its eligibility for the low-income housing tax credit due to a de minimis and good faith error is unfair and could cause substantial uncertainty in the operation of low-income housing developments. Current law already provides penalties in the case of low-income buildings that decrease the number of units that qualify for the low-income housing tax credit by requiring recapture of a portion of the credits previously claimed.

We therefore ask this subcommittee to authorize the Treasury to waive penalties for de minimis errors in the application of the minimum set-aside requirements. This proposal would excuse minor errors in the methodology used to compute rent or determine income while preserving the compliance incentive provided by the recapture provision.

This proposal was contained in H.R. 4210 and in the Senate version of H.R. 11. It was also introduced earlier this year by Senator Mitchell in S. 487. The Joint Committee on Taxation estimates that this proposal would result in a de minimis revenue loss over fiscal years 1994-1998.

Congress Needs to Reconfirm that Sellers May Retain a Portion of Credits Accrued in the Year of Disposition of a Low-Income Housing Building

Under current law, in the event of the sale of a low-income credit building, the seller must recapture the accelerated portion of the credit that was earned for taxable years prior to the sale. The accelerated portion of the credit is the amount of the credit determined for the year (based on a 10-year period) less the amount determined for the year if all credits had been allowed ratably over the 15-year compliance period. The law allows a seller to retain the nonaccelerated portion of the credit earned for prior taxable years. An exception to the requirement that a seller recapture the accelerated portion of the credit applies if the seller posts a bond with the Treasury, and it is reasonably expected that the building will continue to be operated as a qualified low-income housing building for the remainder of the compliance period.

It is unclear, however, whether the seller of a low-income housing credit building is entitled to retain the nonaccelerated portion of the credit accrued during the year of the building's sale that is attributable to the part of the year that the seller provided low-income housing. Sections 42(j)(2) and (3) of the Internal Revenue Code could be interpreted to mean that the nonaccelerated portion of the credit attributable to the seller in the year of sale is not available to either the buyer or the seller. However, this interpretation likely was not the intent of Congress since it is inconsistent with the rules providing that (1) sellers may retain the nonaccelerated portion of the credit earned for all prior taxable years and (2) sellers may retain the accelerated portion of the credit accrued in the year of sale by posting a bond.

If low-income housing is provided in the year of sale, the credit has been earned and a seller should be entitled to retain the pro rata nonaccelerated portion of the credit accrued during that year. Current law allows a seller of a low-income housing tax credit building to retain the nonaccelerated portion of the credit earned for prior taxable years. By analogy, Congress must have intended the seller of a building to retain the nonaccelerated portion of the credit attributable to the portion of the year of sale that low-income housing was provided by the seller.

The Internal Revenue Service appears to agree with this interpretation since it allows sellers to retain the pro rata nonaccelerated portion of the credit in the year of sale as long as a bond is posted. See instructions to IRS Form 8609, Low-Income Housing Credit Allocation Certification, Schedule A, Annual Statement, page 3. While the IRS action is helpful and supports the view that sellers may, under current law, retain the nonaccelerated portion of the credit earned in the year of the sale, the bonding requirement imposes an unfair burden on taxpayers and is inconsistent with the statutory rule which allows a seller to retain the nonaccelerated portion of the credit earned for prior taxable years without posting a bond. We therefore urge the Subcommittee to clarify the Internal Revenue Code to allow the seller of a low-income building to retain the nonaccelerated portion of the credit that was accrued in the year of sale without posting a bond.

The Joint Committee on Taxation has estimated that this proposal would decrease federal revenue by $15 million over fiscal years 1994-1998. However, we strongly disagree with this estimate and the assumptions made to compute it. The Joint Tax Committee estimate improperly assumes that allowing a seller to retain the pro rata nonaccelerated portion of the credit in the year of sale changes the law. On the contrary, our provision merely clarifies existing law and produces the result that must have been originally intended by Congress -- a fact indirectly acknowledged by the Internal Revenue Service in its allowance of sellers to retain the nonaccelerated portion of the credit earned in the year of sale if they post a bond. Our proposal makes the Internal Revenue Code essentially consistent with the current IRS position. Thus, it should have no revenue impact.

Congress Needs to Reconfirm the Meaning of Statutory Language for Purposes of Allocating Credit

Section 42 (f)(4) of the Internal Revenue Code provides that the low-income housing credit shall be allocated between the parties in the year of disposition based on the "number of days the building (or interest therein) was held by each." Despite this clear wording, the Internal Revenue Service has taken the position that the parties must allocate the credit based on the number of months the property is held by each, rather than the number of days, and has refused to allow taxpayers to rely on the clear statutory language of Section 42. Rev. Rul. 91-38, 1991 C.B. 3; Private Ruling TR-31-2079-92 (4/29/93).

We therefore ask this subcommittee to clarify that the allocation of the low-income housing credit between the buyer and seller of credit property may be based on either the exact number of days the property was held by each party or the number of months by using the mid-month convention. According to the Joint Committee on Taxation, this proposal would have no impact on federal revenues.

The Requirement to Obtain Third-Party Verification of Tenant Income from Assets Should be Eliminated

Current law requires state housing agencies to establish procedures that the agency will follow in monitoring taxpayer compliance with the low-income housing credit rules. Section 42(m). Treasury regulations require that the state agency procedures must include, among other things, record-keeping provisions. Reg. § 1.42-5(b). One such record-keeping provision is the requirement that low-income tenants certify their income each year and furnish low-income housing project owners with documentation supporting the certification, including statements from third parties regarding tenant income from assets. Reg. § 1.42-5(b)(1)(vii).

This record-keeping requirement imposes significant burdens on tenants and owners of low-income buildings and is intrusive to existing and prospective qualified tenants. The third-party verification requirement also causes delays in processing tenant qualification as building owners wait for statements from financial institutions and other third parties regarding tenant assets. These delays, in addition to inconveniencing building owners and tenants and imposing unnecessary costs, temporarily deprive prospective low-income tenants of much needed housing. Moreover, third-party verifications of asset income rarely reveal sufficient income to impact a tenant's qualification to occupy a low-income housing unit.

PFS is not advocating modification of the rule requiring verification of tenant wage income. However, PFS believes Congress should authorize the Treasury to allow building owners acting in good faith to rely on a signed, sworn statement from the tenant disclosing the magnitude of the tenant's asset income rather than requiring them to obtain third-party verification. This sworn statement would replace third-party verification (1) when prospective tenants initially apply for rental of low-income units, and (2) when tenants reapply for occupancy, or are recertified.

Conclusion

We would like to applaud Congress for its decision to permanently extend the low-income housing credit program. This program has substantially increased the availability of affordable housing for many Americans and committed many companies like PFS to provide private sector funding for low-income housing. With a permanent credit, additional private sector funding will be committed to the program.

We urge the subcommittee to adopt these six provisions described above which are designed to improve the administration and operation of the low-income housing credit program. These provisions will better enable companies like PFS to carry out Congress' intent by providing modern, suitable housing to those Americans who could not otherwise afford it. PFS is proud of the important role that it and companies like it play in this noble endeavor and looks forward to assisting this subcommittee in fine-tuning the low-income housing credit program to make it even more effective in accomplishing its intended purpose.

Statement by
Mr. Russell C. Notar, CAE
President and CEO
National Cooperative Business Association
to the
Select Revenue Subcommittee
House Committee on Ways and Means
July 13, 1993

Mr. Chairman, Members of the Subcommittee, the National Cooperative Business Association endorses the statement of Ms. Terry Lewis on behalf of the National Association for Housing Cooperatives and urges the subcommittee to correct what we consider to be an improper interpretation of Congressional intent by the Internal Revenue Service. As Ms. Lewis has demonstrated in her statment for NAHC, the Congress never intended for housing cooperatives to be taxed under Section 277 of the Internal Revenue Code.

We appreciate the efforts of the Chairman and other subcommittee members to correct this situation in the past. In the last Congress, two different bills were passed by the Congress that would have settled this matter, but both bills were successfully vetoed by the President for other reasons. We are hopeful that this year the Congress and the President will reach agreement on a tax bill that clarifies, once and for all, that the Congress never intended that housing cooperatives be subject to this tax.

We are grateful that the IRS has apparently yielded to statements of support for our position by many Members of the Congress from both bodies and has granted a moratorium on applying Section 277 to housing cooperatives in order to give the Congress time to act. We hope that legislation can be passed early this year.

Mr. Chairman, we would also like to address the question of retroactivity as it applies to this situation. We understand that certain budgetary issues arise because of this. But I would stress that since the application of Section 277 by IRS has been the result of a misinterpretation of Congressional intent, retroactivity ought not to be an issue. The cooperatives in question ought never have had to pay these taxes. By acting on legislation like HR 1908, the Congress will be making that clear. Indeed, the IRS ought to administratively go back and correct its past actions against housing cooperatives once the Congress has acted to correct their misinterpretation. We would urge the subcommittee to do all it can to ensure that this is accomplished

The National Cooperative Business Association (NCBA) is national, cross-industry membership and trade associatio representing cooperatives--over 100 million Americans and 45,00 businesses ranging in size from small buying clubs to businesse included in the Fortune 500. Founded in 1916 and known for man years as the Cooperative League of the USA, NCBA's membershi includes cooperative businesses in the fields of housing, healt care, finance, insurance, child care, agricultural marketing ar supply, rural utilities and consumer goods and services as well state and national associations of cooperatives.

At our annual meeting in Washington in April of this year, t membership of NCBA renewed our support for correcting this misapplication of Section 277 by IRS. Our membership voted to endorse the following statement directing us to: "Support efforts like HR 537 to amend Section 277 of the Internal Revenue Code of 1986 to clarify the taxation of certain income of housing cooperatives by stating that Section 277 does not apply to housing cooperatives."

We are grateful for the opportunity to express that position by our membership to the committee today. We thank you for holding these hearings and urge you to act swiftly to correct this wrong.

§ 277 and H.R. 1908

I. Summary

The purpose of this memorandum[1] is to analyze the current state of the law taxing housing cooperatives under § 277 and to compare that law with the solutions adopted in H.R. 1908.[2] Our conclusions are that (i) the proposed clarifications are measured and right in line with the current state of the law and (ii) the retroactive clarification is fully justified.

II. Current Status of the Law

A. Our Memo of June 7, 1991

On June 7, 1991, we submitted a detailed 10-page analysis to Joe Gale of Senator Moynihan's office relating to the need for immediate legislation for housing cooperatives. We concluded that the government's position under § 277 was extremely weak on all of the fundamentals of applying a Code provision. Our memorandum can be summarized as follows:

1. *Technical* The government has the uphill battle because it is trying to stretch a statute that (i) was not intended to apply to cooperatives and (ii) literally does not apply to housing cooperatives.

2. *Administrative* The IRS has been ambiguous, late and overreaching in its attack on housing cooperatives. In 1972, the proposed Treasury regulations "Reserved" (i.e., "set aside") on the relationship of § 277 and cooperatives; all proposed § 277 regulations subsequently were withdrawn and have never been reissued. Then, in the mid-80's, the IRS suddenly asserted deficiencies on a group of low to moderate income Mitchell-Lama corporations, and even added huge penalties (under § 6661, for

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[1] This memorandum is submitted by Irving Salem and Carol Quinn of Latham & Watkins on behalf of seven Mitchell-Lama housing cooperatives which have matters pending before the Tax Court or the IRS. The names of the housing cooperatives are Amalgamated Warbasse Houses, Inc., Bayridge Air Rights, Inc., Cadman Towers, Inc., Dayton Towers Corporation, East Midtown Plaza Housing Company, Rochdale Village, Inc. and United Veterans Mutual Housing Co., Inc.

[2] The provisions of H.R. 1908 are identical to those contained in H.R. 11, the Revenue Act of 1992, except for the effective date rules.

lack of substantial authority) despite the literal language of the statute and the lack of official guidance until 1990 (Rev. Rul. 90-36).

3. *Tax Policy* The IRS's position effectively imposes a penalty tax rate (e.g., 46%, rather than a low or zero rate of tax since most of the tenants would pay little or no tax); indeed, this rate also applies to the tenants' own money which is recycled through the grocery store or laundry facilities.

B. Up-dating the Memo - a String of Losses for the Commissioner

1. *Landmark* The significance of Landmark Inc. v. U.S., 25 Cl. Ct. 100 (1992), can hardly be overstated. It is the first judicial decision which directly faced and decided whether § 277 applied to a cooperative. The Claims Court held that the provisions of subchapter T, which focuses on the "Tax Treatment of Cooperatives", applies and § 277 does not apply.

While the IRS makes much of Concord Consumers Housing Cooperative v. Comm'r, 89 T.C. 105 (1987), which applied § 277 to tax interest on reserves, it is often overlooked that the taxpayer (a) conceded that it fell under the § 277 definition (i.e., a membership organization primarily providing goods and services) and (b) did not contend that it was a cooperative to which subchapter T applied. Moreover, the majority opinion expressly declined to consider whether the taxpayer was a "corporation doing business on a cooperative basis" under subchapter T. The concurring opinion noted the potential overlap of § 277 and subchapter T, and wanted this issue decided at a later date. While the Tax Court is presently considering the overlap issue in a long overdue opinion (the lead case was argued and briefed over 4 years ago), the Claims Court has rendered its verdict -- subchapter T preempts § 277.

2. *CF Industries* In an insightful opinion by Judge Posner, the Seventh Circuit in CF Industries v. Comm'r, 1993 U.S. App. LEXIS 12420 (7th Cir. May 26, 1993) recently held that interest on a cash management reserve, voluntarily held for the seasonal cash needs of a very large fertilizer cooperative, was patronage sourced income, even though the direct source of the interest was a bank, etc. The court held that the patronage sourced requirement was satisfied because the earnings on the funds in the cash-management account were generated by the bona fide business dealings of the cooperative, with or on behalf of its member-customers.

Interestingly, although the government conceded that a number of prior court decisions and its own rulings were indistinguishable from the CF Industries facts, the government urged the court to treat the income as arising from an "investment in securities", which under its regulations would be treated as nonpatronage sourced income. Judge Posner went on to reject the government's rather audacious request:

> The government wants us to reject all the previous appellate decisions in order to create an intercircuit conflict that might invite Supreme Court review. Yet it has neither repudiated nor plausibly distinguished the early revenue rulings that provide the foundation for the judicial decisions. The government is in a dilemma largely of its own creation. It has rested upon a Treasury Regulation that is hopelessly equivocal, and has made, so far as appears, no effort to amend it. It has also failed to identify any abuses--any attempts by cooperatives to act as the tax-exempt investment agents of its members--of the sort the statute and regulation might have been supposed to be aimed at preventing. It invites us to give it a better shot at the Supreme Court by creating an intercircuit conflict. We decline the invitation. (Emphasis supplied, footnote omitted.)

The CF Industries case is consistent with the holding of a recent Tax Court case (Dundee Citrus Growers Association, 62 T.C.M. 879 (1991)), in which the court found that the temporary deposits comported with "sensible business practices" and were patronage sourced income since they were "inseparably intertwined" with the overall conduct of a cooperative enterprise.

3. *Recent IRS Positions are Consistent with the Position of the Taxpayer on Certain Crucial Issues*

a. *Housing cooperatives are subject to subchapter T.* Although the IRS's litigating position appears to question whether subchapter T applies to housing cooperatives, all of the applicable decisions point to the contrary. This was confirmed in a letter dated July 24, 1991 from Michael Murphy, Industry Specialist, to Ms. Tracey M. Smith of Doherty, Rumble & Butler. Mr. Murphy acknowledged the favorable case law in the following language contained in a proposed memorandum attached to his letter:

> While there currently are no court opinions directly on point, as early as 1972, the Tax Court stated that subchapter T applied "to the taxable year of any corporation operating on a cooperative basis after December 31, 1962, and that necessarily includes a section 216 cooperative housing corporation." Park Place, Inc. v. Commissioner, 57 T.C. 767, 779 (1972); See also, Concord Consumers Housing Cooperative v. Commissioner, 89 T.C. 105 (1987); Concord Village, Inc. v. Commissioner, 65 T.C. 142 (1975).

b. *The IRS's test for determining patronage sourced income would cover certain commercial income.* The IRS released a coordinated issue paper (reprinted in the Daily Tax Report on October 29, 1992) considering whether the rental income of a cooperative was patronage sourced. Although the ultimate decision was unfavorable to the taxpayer, the issue paper states that "if the rental transaction advances the cooperative's marketing, purchasing, or servicing activities with or for patrons" the rent should be considered to be patronage sourced. Since providing a convenient grocery store and shopping area advances a Mitchell-Lama housing cooperatives' basic purpose of providing safe, affordable housing, taxpayers can now turn to the IRS's own words for support.

III. Comparison of Existing Law and the Rangel Bill (H.R. 1908).

A. Description of Bill

H.R. 1908 places housing cooperatives described in § 216 under subchapter T (and excludes them from § 277). This is consistent with the Landmark case, the only case to squarely face the issue. The other principle provisions of H.R. 1908 are as follows:

1. *Interest, Laundry and Parking* Interest on reasonable reserves (including reserves required by a governmental agency or a lender), and income from laundry and parking (to the extent attributable to tenants and guests), are deemed to be housing related and therefore may be offset against the cost of providing housing. This result follows from the position taken by the courts in applying the basic test under subchapter T, as so forcefully articulated in CF Industries.

2. *Commercial Income* With respect to limited equity housing cooperatives, which remain affordable to potential low to moderate income purchasers by controlling resale prices, rental income from commercial and professional space located at the site of the cooperative housing development also would be deemed to be housing related. For this purpose, a limited equity cooperative is one that meets the tests in § 143(k)(9)(D), that is, a cooperative in which the selling tenant-stockholder can only receive amounts equal to the sum of the (a) amounts paid by the first tenant-shareholder (adjusted for inflation) and (b) amounts paid by any tenant-shareholder for improvements and mortgage amortization.

This result would also seem to be reasonable under subchapter T authorities (including the IRS analysis) since the commercial space is authorized by a governmental agency and is an integral part of the advancement of the subsidized housing development. Further, it seems fair not to tax the income from the lease of the grocery or other commercial stores since a very substantial portion of such income can be traced to monies paid by the resident-owners in the development.

3. *Adoption of Farm Services Principle* To insure that no inappropriate tax advantages are created, a specific provision is added to the Code preventing the set-off of losses related to housing against unrelated income. This provision codifies the IRS's victory in Farm Services Cooperative v. Comm'r, 70 T.C. 145 (1978), rev'd on other grounds, 611 F.2d 1270 (8th Cir. 1980); this is viewed as an important case by the IRS which it wants codified.

B. Retroactive Application

The case for retroactive application is very strong. The recent developments discussed above, plus the codification of the Farm Services principle, suggest that the true revenue loss may be very small. In addition, there are compelling policy reasons suggesting the better answer is to clarify the law on a retroactive basis.

The IRS has proposed deficiencies dating back to 1981 in connection with some of the pending cases. And despite the ambiguous statutory language and lack of official guidance until 1990 (i.e., the publication of Rev. Rul. 90-36), the IRS has added a 25% penalty tax to the outstanding tax bills. The litigation process is moving very slowly and is likely to go on for many more years. Given the large number of taxpayers who could suffer serious economic harm, the issue may require a resolution by the Supreme Court. Accordingly, a final resolution could cover 10-15 years of tax deficiencies.

Even if the government were successful, the tax may in many cases be borne by the wrong party. The current tenants have not been assessed by the cooperative and probably cannot be assessed because of the speculative nature of the liability. If the choice is patching the roof or setting aside funds for a potential adverse tax decision, the roof repair likely will prevail. If a surcharge is assessed on the tenants after the issue is lost, the wrong family often will be asked to pay the tax because of the turnover in the intervening years. Moreover, if the final verdict is negative, the then current tenant may not be able to pay such a large amount in a lump sum. In particular, a much higher rate (effectively a penalty rate) would apply than if the tenants had received the income directly.

This raises the possibility of losing precious affordable housing stock because a limited-profit housing cooperative may have to privatize in order to raise funds with which to pay the tax. Thus, it is feasible that the IRS may compel the termination of the very class of housing Congress has been fighting to preserve.

In short, if the Congress agrees with the clarifications contained in H.R. 1908, retroactive relief follows from both the standpoint of the small revenue loss and tax and housing policy considerations.

Statement of Congresswoman Nita M. Lowey
Before the Subcommittee on Select Revenue Measures
In Support of H.R. 1418

I thank the Committee for this opportunity to testify on behalf of H.R. 1418, legislation that would alleviate an inequitable tax situation which is affecting a number of my constituents.

As my colleagues on the Committee are aware, in a typical housing cooperative, the tenant stock-holders pool their assets to purchase both land and houses. When the cooperative takes out a loan to make a purchase, the interest on the mortgage can be deducted individually by the members against their personal income. Additionally, property taxes that are assessed to the cooperative can be deducted individually by the members.

However, a group of my constituents are treated differently. The residents of the Edgewater Park Cooperative own their own homes, while collectively the co-op owns the land on which the homes stand. Because their arrangement is unusual and it does not fit with the IRS definition of a cooperative, they are not allowed to deduct their share of the mortgage interest or the property taxes that the cooperative incurs from their personal income taxes.

They are not covered by the IRS cooperative rules because of their unusual but not unique arrangement. It stands to reason that if one is a member of a cooperative and contributes to paying the cooperative's mortgage interest and property taxes, then that person should be allowed to deduct those costs when paying their taxes, regardless of whether the individual ownership rights to a home are retained.

H.R. 1418 would address this inequity. It would allow individuals who belong to cooperatives to deduct mortgage interest and local taxes from their tax liability even if they own their own homes. There is no opposition to the legislation that I am aware of, and the bill would only affect clearly defined groups of individuals. It would have a relatively minor impact on the Federal Treasury, but would make a real difference to those taxpayers affected. Furthermore, it is a matter of simple equity.

I urge the Committee to approve H.R. 1418.

Written Statement of Mr. Bernard Rodin
on Behalf of
J&B Management Company
Subcommittee on Select Revenue Measures
Committee on Ways and Means
July 13, 1993

In Support of the Housing Preservation Deduction

I am Mr. Bernard Rodin, a general partner of J&B Management Company. The company is a general partner in various partnerships that own low-income housing projects assisted by HUD. In addition, J&B partnerships own and operate a number of market rate units, including a number of luxury rental retirement communities. Altogether, I have had almost 25 years experience owning or managing residential housing in many parts of the U.S.

I urge the Committee to approve the proposal for a housing preservation deduction supported in testimony received at the Subcommittee's hearings on July 13. As described in the Subcommittee's June 2nd press release, the proposal would provide for a housing preservation deduction, consisting of a 15-year straight line depreciation and an exemption from the passive loss rules, for new investors in certain privately-owned low-income housing projects.

Description of the Housing Preservation Deduction Proposal

The Joint Tax Committee has estimated that this proposal would only cost a total of between $56 million and $157 million over five years, depending on the exact terms of the proposal. The Joint Tax Committee estimate was based on the assumption that the proposal would contain the following key elements:

- Purchaser of an eligible low-income project may claim 15 year straight line depreciation, and passive loss rules are inapplicable.
- Eligibility is limited to low-income housing projects subsidized by HUD under Section 221(d)(3) Below Market Interest Rate and Market Rate Programs, under Section 236, or under Section 221(d)(4) of the National Housing Act.
- At least 50% of the units in any eligible project must house tenants with incomes less than 80% of area median income, and in the case of projects operating under the Section 221(d)(4) or Section 221(d)(3) market rate program, at least 50% of the units (or the units' tenants) must be receiving Section 8 rental assistance.
- Purchaser must expend on rehabilitation an amount equal to at least 10% of the purchase price, and the project must continue to serve low-income tenants.
- Project must be at least 10 years old at time of sale.
- Projects that are part of a like-kind exchange, or that are sold to related parties, are not eligible.
- Purchaser may not also participate in the low-income housing tax credit program, the Low-Income Housing Preservation and Resident Homeownership Act of 1990 (LIHPRHA), or the Emergency Low-Income Housing Preservation Act of 1987 (ELIHPA).

The Nation's Aging Low-Income Projects Have No Way to Meet their Increasingly Urgent Capital Needs.

I know from my own involvement in the industry, that many of the existing low-incoming housing units assisted under the Section 221(d)(3) or Section 236 programs of HUD are seriously aging projects with significant physical and financial needs. This is because these projects were built under programs that date from the 1960s or earlier. The 221(d)(3) and 236 programs were all suspended by the mid 1970s, so the projects are at least 15 years old, and in many cases much older than that. Section 221(d)(4) projects subsidized under Section 8 which are at least 10 years old are also threatened by serious physical deterioration.

The Administration's economic recovery plan recognized the importance of addressing the needs of the aging housing stock when it called for immediate steps to "repair and restore the nation's stock of assisted rental housing, most of which is 20 to 30 years old. Many units are in deteriorated buildings. Many operators of buildings are also financially troubled." Because the owners lack the necessary capital to repair the projects, the tenants of these properties are condemned to live in projects that remain in substandard condition.

What the projects need to do above all else is raise additional capital. In almost all cases, however, it is simply not a realistic option to seek additional capital from those currently investing in the projects. This is because the current owners have no incentive to invest additional amounts of their capital in projects that are providing little or no return to them.

At the same time, there are no existing federal programs that effectively address the additional capital needs of the projects that are at risk. With very few exceptions, the low-income housing tax credit has simply not been used to preserve existing low-income units. The program is an excellent one, and it has been effective in generating new units of low-income housing, but it has had minimal effect on preserving the country's existing stock of low-income housing.

Nor is it possible for the current owners simply to sell the projects to new owners who have raised additional capital from private investors. There are two major obstacles blocking any realistic chance to do this under current conditions.

The first problem is that in the current depressed real estate market, the existing owners can not afford to sell the projects. If they did so, their investors would suffer out of pocket losses. This is because the 1986 changes in the tax law, and the general aging state of the projects, have substantially reduced the market value of the projects. Should the current investors sell the projects, they would receive less in cash than they would have to pay in capital gains taxes on the difference between the depreciated basis of the property and the sales price (calculated to include both the cash received and the mortgage liability assumed).

Many of the investors are advancing in age. Rather than sell their interests in the projects, and incur an actual out-of-pocket loss, they have the option of leaving their interests in their wills to their heirs. The latter would inherit the interest with a stepped up basis, thereby avoiding payment of capital gains taxes on the interest completely.

Simply forgiving the exit taxes that the current investors would otherwise owe upon the sale of the project would not solve the problem. In the absence of some new incentives, few investors would be interested in buying the projects from the current investors and putting new capital into the projects. Under current conditions, these aging low-income housing projects simply are not attractive investments for people with money to invest.

The Proposal Would Raise the Needed Capital and Advance U.S. Housing Policy.

What is needed most is not direct federal assistance, but action to remove the serious obstacles that now discourage the sale of the projects to new investors with additional capital. The housing preservation deduction would provide an effective and permanent solution to the problem. It would do so in a way that is practically revenue neutral.

The proposal would be effective in part because it would be likely to result in a modest increase in the market value of the projects over their current depressed levels. This, in turn, would make it possible to sell the projects for enough to pay the capital gains taxes that will be due upon sale.

The deduction would also make it possible to attract additional capital for the projects from new investors. Based on my years of experience raising equity capital from individual investors, I am confident that this approach would appeal to relatively small investors. New investors would be interested because they would have a chance to ensure a limited but reasonable return on their investment, while simultaneously promoting a solution to a pressing public need.

At the same time, the proposal offers an equitable solution to the problem. Investors who previously deferred taxes through the depreciation deductions they took would pay capital gains tax at the time of the sale. As evidenced by the fact the proposal is practically revenue neutral, this is not a matter of opening up some large new "tax loophole." While the approach would provide some additional tax benefits to the new investors, the Treasury would at the same time "recapture" tax benefits previously provided the existing investors. Furthermore, unlike the housing credit, the proposed deduction is a deferral rather than a credit. As a result, when the new investors in turn sell the project, they too will be subject to capital gains taxes to the extent the sales price exceeds the property's depreciated basis.

Equally importantly, the approach also makes good sense from the point of view of this country's housing policy.

- The proposal ensures that the projects will continue to be maintained for low-income tenants, since the deduction will only remain available for as long as the project remains a low-income housing project.
- The infusion of new capital will directly benefit the tenants, who will be able to live in newly rehabilitated units.
- The proposed approach avoids the high administrative costs and threat of politicalization that inevitably accompanies traditional housing grant programs.
- By avoiding any need to allocate benefits on a state-by-state basis according to population, such as is the case with the tax credit, it eliminates the potential

mismatch between a state's actual needs and the size of the program in that particular state.

- It provides a way to target benefits to those low-income housing projects that are aging and at risk. According to HUD analysis, there are roughly 8500 projects which would qualify for the proposed deduction in accordance with the specific criteria described above. These projects are located in every state of the Union.
- Because HUD must approve the sale of each of the projects, HUD will review each transaction on a case-by-case basis to ensure that it is on terms that will benefit the project, and promote the interests of the tenants. For example, if HUD concludes that the project requires more than 10% of the purchase price in capital improvements, the purchaser must agree to the additional work before the sale can go forward.
- Preserving the existing low-income housing is more economical, and provides more immediate benefit to the overall economy, than programs that emphasize the construction of new housing.

* * * *

In summary, the preservation deduction will create a genuine "win-win" situation. It will improve the quantity and quality of housing available to the people in this country with low-incomes. It will complement the Administration's overall economic recovery plan by enacting a program with little or no cost to the Treasury that at the same time enhances investment in the nation's infrastructure, improves the standard of living for the country's poorer residents, and revitalizes local communities.

I urge the Committee to adopt the proposal.

ALASKA
AEROSPACE
DEVELOPMENT
CORPORATION

TESTIMONY OF
H.P. "Pat" Ladner, Executive Director
Alaska Aerospace Development Corporation
to
U.S. House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures

Thank you for providing me with the opportunity to testify to the Committee on Ways and Means on an important and timely issue: the extension of tax exempt status for facility bonds issued by spaceports.

Federal law currently provides the same tax exempt status we are requesting today for facility bonds that are issued to finance facilities related to other modes of transportation -- including airports, docks, and wharves. That status has produced significant benefits for this nation at minimal cost by making the nation's air and sea transportation industries more competitive.

By extending the same tax exempt status to facility bonds issued by spaceports, Congress would enhance the competitiveness of a third transportation industry -- space launch.

Today the space launch transportation industry is at the same juncture as the air transportation industry was four decades ago, in the 1950's, just after World War II. That is, the space launch transportation industry is a fledgling industry in need of minimal federal assistance in order to boost existing participation from state and private investment.

In 1992, U.S. launch industry sales added $400 million to the nation's economy. That number can grow if the nation invests in the development of new, and the improvement of existing, space launch infrastructure.

If the nation does not invest in this infrastructure, the space launch industry will no longer be able to provide the nation with cost-effective, reliable transportation to space. Instead, the space launch industry will lose its significant share of an increasingly competitive international market and the nation will lose yet another industry in which it has previously led the world.

There are eight existing and proposed government owned and operated spaceports in the United States. They are located in my home state of Alaska as well as in Florida, California, New Mexico, Virginia, Hawaii, Texas and Mississippi.

Extension of the tax exempt status to spaceport facilities will benefit not only these eight spaceport states but also states such as Colorado, Alabama, Tennessee, and Utah in which space launch equipment is manufactured. Each of those states requests your support for the extension of tax exempt status to spaceport facilities.

Thank you for your time and attention to this important and timely issue.

3601 C Street • Suite 1400 • Anchorage, Alaska 99503 • (907) 561-3338 • FAX (907) 561-3339

TESTIMONY BEFORE THE HOUSE WAYS AND MEANS COMMITTEE
US HOUSE OF REPRESENTATIVES

Tax Exempt Status for Spaceports

The Honorable Casey Luna
Lt. Governor of New Mexico

Mr. Chairman, members of the Committee, I want to thank you for the opportunity to speak to you about a change in tax law to place spaceports in the same category, for tax purposes, as airports and seaports.

This proposal should raise several questions in your mind, not the least of which is, how much will this cost? If you will permit me, I would like to defer the question of cost until after two other questions are addressed; First, why spaceports? and second, why now?

The development and utilization of seaport and airports as funnels for economic development. Certainly the use of the sea-lanes as the primary conduit for international trade is centuries old. But it has only been in the last two decades, with the advent of the machinery to make containerization a viable activity that the idea of both airports and seaports as industrial and commercial centers rather than as points for trans-shipment has truly taken hold. The seaport of today is not merely docks and warehouses, but is a center for manufacturing and industrial centers, not merely as a place to send or receive goods. Seaports and airports have ceased being like a railroad station. But they are part transportation center, part industrial park. The alliance in Fort Worth as envisioned by Ross Perot is more a mirror of what the modern airport has become than a new way of conducting business.

Provisions of federal tax law have fostered this new conception of the airport and seaport as a center for industry, not merely for commerce. The exemptions provided for certain commercial and industrial activities in and around airports and seaports have served as a catalyst for this new way of thinking, about airports and seaports. These exemptions, therefore, have proven an important aid to commerce.

Having said that, I do not want the central idea of these facilities to be lost. The logic of combining an industrial park with a transportation center is fundamental to the viability of the idea. This is not simply an amalgam of activities brought together to fit the tax laws. Rather this is an economically viable response to the "global economy" that is helped and encouraged through the tax laws. The industries that cluster around an airport or seaport do so because the access to transportation is critical to the profitability of those industries. Furthermore, I would not necessarily expect the same type of industry to seek out a seaport that might utilize a mid-continent airport.

It is for this reason that we recommend to you that spaceports be treated in the same way as seaports and airports. There are numerous industries for which access to space for research, development and testing is critical. In other words, a spaceport, no less than a seaport or airport, can form the centerpiece of a major industrial complex. The economic advantages are equally viable for a spaceport as for other "ports." I think you can see the logic of what I am trying to suggest. If I may digress only slightly I would like to address how the State of New Mexico is approaching a parallel infrastructure matter. In 1991, the New Mexico Legislature created the New Mexico Border Authority. The mandate of that agency was to finance infrastructure as part of a broader economic development strategy for our 180-mile border with Mexico. The models we used for this legislature were the Virginia and Seattle Port Authorities because of the emphasis on economic development in these seaports. We may yet use revenue bonds from the Border Authority to finance infrastructure development at the regional spaceport to be managed by a multi-state Spaceport Authority we will construct in the next couple of years. The point is that a seaport authority served as the model for an economic development activity. The logic would hold had we created a Spaceport Authority first, rather than the Border Authority.

The next question to be asked is "Why now?" Unlike seaports and airports, there are few spaceports. In truth there are unlikely to be many more for a number of years. But that is precisely why the tax laws should be changed now. Given the very different cost factors associated with spaceports and space research activities the need to encourage the clustering of such activities around spaceport sites is great. The ability to treat a spaceport as a research/industrial park represents a boost to the spaceport, but indirectly for all involved in space research, development and commercialization. If the cost of access to space is critical, and it certainly is for the private sector, than the synergy of creating a spaceport/research. Complex represents an important potential cost savings. To treat spaceports like seaports and airports for tax purposes provides a boost to commercial space industries more than it does a particular spaceport. Now is the time to insure that we in this country can be the leader in converting space research and development into commercial and industrial enterprises. We must begin now to encourage this transformation and development. Thinking about spaceports as more than merely a launch site can be part of the strategy.

The final issue I wish to address is the cost in terms of revenues foregone. In the short-term there will be a cost to the federal government, though given the small number of spaceports now in existence, or in the planning stages, the costs are relatively small. I would also have to assume that the states and local governments will see the benefit in terms of increased economic activity will generate far more in taxes at all levels of government than will be lost through the provisions of the tax laws we seek to amend.

The benefits in promoting commercial space activities exceed the costs of this change, even in the short term. But the long term benefits are still greater. We "discovered" the economic potential of airports and seaports and they were reshaped. Now is the time to make use of that discovery at the point in development of spaceports that the economic factors can be part of the overall design for most such facilities. Changing the tax laws can be the catalyst for that design.

I want to thank you for the opportunity to present my views. If you have questions about my testimony, please feel free to contact my office in Santa Fe, New Mexico.

Alaska Housing Finance Corporation

Statement With Respect to H.R. 1289

Dated July 16, 1993

The State of Alaska offers, through the Alaska Housing Finance Corporation, a Veterans Loan Program funded with the proceeds of Qualified Veterans Bonds. This program assists veterans in obtaining lower cost financing for home purchases - permitting many to purchase a home who may not otherwise be able to and others to purchase a home more suitable to their particular family situation.

The definition of "qualified veteran" contained in Section 143(l)(4) of the Internal Revenue Code of 1986 limits program benefits to those veterans who entered active duty prior to January 1, 1977 and who have not been out of active service for more than 30 years. As a result, many veterans are no longer eligible to participate in programs financed by tax-exempt Qualified Veterans Bonds.

This restrictive definition denies veterans of post-Vietnam conflicts the opportunity to participate in our Veterans Loan Program. Members of our Armed Forces who were sent to Latin America, Grenada, Lebanon and Desert Storm are excluded. Likewise, veterans of conflicts in Macedonia and Somalia return to find they are ineligible for the program.

The current definition forces states with active programs to create two classes of veterans - those who qualify and those who don't. As the administering entity for this veterans benefit program, it is very difficult to respond to the post-1976 veterans who ask why they are ineligible for our Veterans Loan Program. How is one to respond other than that Congress somehow values the service of the pre-1977 veteran greater than that of the more recent veteran?

While Alaska is the largest state geographically, it has one of the smallest populations. The proportion of Alaska residents serving or having served in the Armed Forces, however, is amongst the highest. According to the 1990 Census, over 40% of Alaska's male population over sixteen years of age was then serving or had served in the Unites States Armed Forces. Alaska contains the only territory of the United States held by a foreign entity through hostile conflict - Attu Island occupied by the Japanese during World War II. Consequently, great importance is placed on providing recognition to veterans choosing to reside in our state. The same recognition should be given to those who served in Desert Storm as is given to Vietnam Veterans.

Congressman Mike Kopetski from Oregon has introduced H.R. 1289 which would permit each State with an active program to establish their own eligibility requirements. The bond issuance volume caps applicable to each of these states would remain unchanged. Congressman Kopetski has several alternatives proposed to eliminate any tax revenue loss which may be attributable to the change.

The flexibility to allocate the permitted bond volume in the most equitable manner possible is critical. Accordingly, favorable consideration of H.R. 1289 or one of its alternatives is encouraged.

STATEMENT OF MR. GARRY MAURO
TEXAS LAND COMMISSIONER AND
CHAIRMAN OF THE TEXAS VETERANS LAND BOARD
TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HEARINGS ON H.R. 1289

July 20, 1993

Mr. Chairman and Members of the Select Revenue Subcommittee:

Thank you for the opportunity to express my support for H.R. 1289. As you are aware, section 148(l)(4) of the existing Internal Revenue Code (the "Code") makes veterans who did not serve on active duty some time before January 1, 1977 ("post-76 veterans") ineligible to receive low-interest home mortgage loans from the proceeds of tax-exempt qualified veterans mortgage bonds. H.R. 1289 would amend section 148(l)(4) to make all veterans eligible to receive mortgage loans funded with tax-exempt qualified veterans mortgage bonds regardless of when they commenced active service.

I earnestly solicit your support of H.R. 1289. At stake is whether thousands of veterans who have honorably served their nation will be able to afford and obtain safe, decent housing.

Texas has a long history of rewarding veterans for protecting our freedoms and democratic ways. In the early days, when the frontier stretched for seemingly endless miles, veterans were given grants of land. Today, we continue that tradition with a program of low interest land and housing loans. This program generates an enormous amount of economic activity, furnishing crucial jobs in low-income rural areas as well as the larger metropolitan areas.

When I was first elected land commissioner in 1982, I acted at the request of veterans organizations and sought to add a housing component to what was then solely a land program. The Legislature and the voters agreed, and now Texas veterans are able to buy a home as well as purchase land by participating in this program.

In 1983, the voters approved $500 million in general obligation bonding authority to finance the housing program, and the Legislature put the full faith and credit of the state behind it. In 1985, because of the popularity of the program, it became necessary to seek an additional $500 million in bonding authority. That also was overwhelmingly approved by the voters.

With interest rates down and home loans being made at a record pace in recent months, we must go to the voters once again. Earlier this year, the Legislature approved another $500 million in constitutional authority, and the voters are expected to give their strong endorsement in a November 2 amendments election.

But the program is being inexorably squeezed, and this is where we need your help. Because of language in the 1984 federal tax law, we are limited in our ability to serve our youngest veterans -- those who served in the Grenada, Panama and Desert Shield/Storm actions and those now in Somalia and other troublesome, often dangerous, places around the world. The law narrowed loan eligibility to those veterans who had served before 1977.

In 1984, Congress could not have anticipated the need for continued U.S. military presence in so many foreign hot spots and surely would not have intended to exclude the nation's younger veterans from benefits that include affordable housing. We view our program as a way of paying a debt that we owe.

Our veterans have earned this benefit. Texas and four other states have veterans having programs. We respectively ask that you support H.R. 1289 so that we may continue to assist veterans and their families who simply want their own homes.

VETERANS
AFFAIRS

STATE OF WISCONSIN, DEPARTMENT OF VETERANS AFFAIRS

30 West Mifflin Street, P. O. Box 7843, Madison, WI 53707-7843
Tommy G. Thompson, Governor
Raymond G. Boland, Secretary

July 20, 1993

Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
1102 Longworth House Office Building
WASHINGTON DC 20515

RE: Wisconsin Support of Amendment to Internal Revenue Code Provision Governing Qualified Veterans Mortgage Bonds.

Dear Ms. Mays:

Wisconsin has long supported amendment of section 143(1)(4) of the Internal Revenue Code to include within the definition of "qualified veteran" those veterans who have entered active duty since January 1, 1977. Included are the men and women who served in Panama, Grenada, Lebanon and the Persian Gulf.

Wisconsin has provided primary mortgage home loans funded by tax-exempt bond proceeds to its veterans since 1974. The home loan program has been of tremendous benefit to Wisconsin veterans, allowing thousands of them to become homeowners. Those home sales generated business for Wisconsin's construction contractors, mortgage lenders and real estate brokers and salespersons. And those new homeowners in turn provided a significant boost to the state's general economy.

Because of the current I.R.C. definition of "qualified veteran", Vietnam veterans are the last to benefit from the program. This is not fair. Those serving their country since Vietnam are every bit as entitled to the benefit.

The sole reason for denying the benefits of the program to those veterans is that the issuance of tax-exempt bonds to fund the home loans has an adverse effect on the U.S. Treasury. But Wisconsin can provide the benefit to its post-1977 veterans without exceeding the bond volume limitation set by Congress at the time it adopted the restrictive definition of "qualified veteran". Furthermore, Wisconsin and the other affected states have proposed a number of options to the Committee which would further hold down costs to the Treasury.

In any event, the cost to the Treasury would be small. The benefits which could be extended to post-1977 veterans upon amendment of the law would be great.

Wisconsin respectfully requests passage of an amendment to the definition of "qualified veteran" in section 143(1)(4) of the Internal Revenue Code to include veterans whose active service has occurred since January 1, 1977.

Sincerely,
DEPARTMENT OF VETERANS AFFAIRS

DANIEL D. STIER
Deputy Secretary

cc: The Honorable Gerald Kleczka, U.S. House of Representatives
The Honorable Mike Kopetski, U.S. House of Representatives

STATEMENT OF THE COUNCIL OF DEVELOPMENT FINANCE AGENCIES IN SUPPORT OF H.R. 2111

BEFORE THE SELECT REVENUES SUBCOMMITTEE OF THE HOUSE WAYS AND MEANS COMMITTEE

JULY 13, 1993

Mr. Chairman, the Council of Development Finance Agencies (CDFA) is pleased to indicate its strong support for H.R. 2111, legislation that would both permanently extend the small-issue industrial development bond program and provide an increase in the capital expenditure limitation for IDB-financed projects from $10 million to $20 million for expenditures made after the date of the bond issue.

CDFA represents over 100 state and local government finance agencies in 38 states. These are the government agencies that are the most directly involved in state and local efforts to provide critical financing for business growth. Our members frequently are the ones who supply the access to capital that enables smaller companies to grow and create jobs.

Our members report that the existing capital expenditure limitation is a major impediment to economic growth and job creation for many smaller manufacturers. Because those companies need the access to affordable, long-term capital provided by small-issue industrial development bonds, they must accept the present restrictions that accompany the use of those bonds. Yet the capital expenditure limit--which restricts the total amount of capital investment that may be made in a plant financed by these bonds--unnecessarily restricts small companies' ability to use state-of-the-art equipment and denies them flexibility to take advantage of opportunities for growth and expanding market share. Most significantly, the current limit has the perverse effect of penalizing companies that experience rapid and sustained growth. Companies that are highly successful as a result of the investment made with small-issue industrial development bonds may be forced to limit their expansion for the three years succeeding that investment or lose the tax exemption of the bonds. This limitation hurts the growth of precisely the companies that as a nation we should want to encourage.

This problem is a national one. From California to Illinois to Massachusetts to Georgia, CDFA's members report numerous specific examples of smaller manufacturers who are unable to go forward with plant expansion plans, and the additional jobs those expansions would yield, because of the existing limit on the amount of private investment that can be made in an IDB-financed project. Typically, these plans call for total capital investment in the $12-14 million range, underscoring that these remain small projects, yet they would put the project over the current $10 million threshold.

H.R. 2111, sponsored by Rep. Ted Strickland, would give manufacturers greater flexibility for growth by raising the limitation on capital expenditures by an additional $10 million for capital investment that occurs after the tax-exempt bonds are issued, thus allowing them to respond to increased sales or changing market conditions.

Current law provides that the total amount of private investment in an IDB-financed manufacturing facility cannot exceed $10 million during a six-year period that begins three years before the bonds are issued and ends three years after the bonds are issued. That provision was established fifteen years ago, in 1978, and it has not been modified since then.

The original goal of the 1978 provision was to ensure that small-issue IDBs are targeted to smaller companies. Since the $10 million limit was created, the amount of capital required for smaller manufacturers has increased significantly. While much of this is the consequence of inflation, some of if flows from the fact that most manufacturing facilities now must make larger investments in technology-based equipment and plant operations. Although this equipment can greatly enhance productivity, making the company more competitive, it is frequently much more expensive than older machinery which it has replaced. Consequently, the capital needs of smaller companies are much greater than they were fifteen years ago. The companies remain small companies, frequently locally owned; they simply required a larger capital base.

In addition, with the growth of international competition and domestic high-technology marketing and distribution systems, companies need the ability to respond quickly to changing market circumstances. If they must wait two or three years for a plant expansion whose production capacity will satisfy market demand, they may find it difficult to remain competitive. There is no compelling reason for forcing them to forego these opportunities for growth just because they have benefitted from tax-exempt finance.

H.R. 2111 does not require any reconsideration of the underlying philosophy that led to the imposition of the $10 million limit back in 1978. The changes envisioned by H.R. 2111 would not alter the IDB program's focus on smaller manufacturers. Indeed, merely adjusting the limit for the inflation that has occurred since 1978 would produce a new limit of over $23 million.

It is also important to note that H.R. 2111 does not address the current limit on the amount of tax-exempt financing available to smaller manufacturers. Each facility would continue to be limited to no more than $10 million in tax-exempt bonds. It only permits additional private capital to be invested in an IDB-financed plant. Furthermore, it does not alter the current law's requirement that the IDB program be targeted to manufacturing facilities. H.R. 2111 is, instead, narrowly focused, modest legislation that could nevertheless make an important contribution to the growth of the nation's smaller manufacturing sector.

Last year Congress approved similar provisions as a part of H.R. 11. These provisions were included without opposition in the Senate and quickly agreed to by the conferees. CDFA fully endorses H.R. 2111 and hopes that the Committee will be able to incorporate its provisions into the budget reconciliation bill. We encourage the Committee as well to take an additional, simplifying step and simply make a straight-forward adjustment of the capital expenditure limit over the entire 6-year period.

Raising the capital expenditure limit will recognize the reality of the capital needs of small manufacturing facilities and will allow these companies to expand, taking advantage of market growth to create additional jobs.

Request for Modification of a 1986 Transition Rule to Permit the Use of Unexpended Proceeds of a Bond Issue to Repair Extensive Damage to Stanford University Caused by the 1989 Loma Prieta Earthquake

Submitted to the
House Committee on Ways and Means
by Peter Van Etten, Chief Financial Officer, Stanford University
July 13, 1993

In 1986, when the Tax Reform Act imposed a cap of $150 million on the amount of tax-exempt bonds private universities could issue, Stanford University requested and was granted a transition rule allowing the university to issue an additional $105 million in bonds to construct and renovate student housing and research facilities in the Near West campus. Stanford is asking that earthquake repairs be added to the permissible uses for the funds obtained pursuant to the 1986 transition rule. This modification will cost the U.S. Treasury nothing, as the bonds have already been issued.

Specifically, Stanford University is requesting that the language in the Act be amended to permit the university to use part of the proceeds of the bonds authorized under the transition rule to help the campus recover from the severe damage it suffered as a consequence of the 1989 Loma Prieta earthquake.

By way of background, Stanford requested the transition rule in 1986 to allow the university to complete several specific projects that were in the planning stages at the time the limitation on tax-exempt financing was enacted. Approximately $102 million of the $105 million in bonds was issued.

Subsequent to the sale of the bonds, Stanford was severely damaged by the 7.1 magnitude Loma Prieta earthquake that struck the Bay Area on October 17, 1989. Damage to the campus amounted to $120 million dollars. Two hundred structures on campus were damaged, and over twenty-five were declared unsafe and closed by the county. Many of these structures, including the main library and other key academic buildings, remain closed today.

Stanford has been forced to defer previously planned projects and to concentrate its financial resources on reconstructing damaged portions of campus and reinforcing buildings on campus that need seismic bracing. Because of the severe financial and capital constraints, Stanford cannot use the bonds for the original purposes for which they were issued.

The amendment Stanford is requesting would permit the university to utilize the unused portion of these bonds — approximately $50 million — to finance earthquake recovery projects on campus. Projects that might be undertaken include: repair of buildings damaged in the earthquake, structural bracing of campus facilities not damaged in the earthquake, and construction of new facilities to accommodate departments displaced by earthquake damage. The amendment would also exempt the bonds used for earthquake projects from the TEFRA notice and hearing requirements (Section 147(f) of the Internal Revenue Code), since these requirements must be fulfilled before the bonds are issued.

Again, the requested modification will cost the U.S. Treasury nothing. The bonds have been issued, but they remain unused because the university cannot now afford the projects for which they were originally intended. In the meantime, Stanford is struggling to finance repairs to major academic buildings that remain closed due to earthquake damage. It makes little sense to have bonds issued but unavailable to assist in helping the campus recover from a major natural disaster.

Stanford University requests that Congress modify the original transition rule, as stated below, to permit a portion of the proceeds from the bonds issued under that rule to be used for earthquake-related projects.

Proposed Transition Rule Modification

(A) Subparagraph (J)* of paragraph (33) of Section 1317 of the Tax Reform Act of 1986 is amended to read as follows:

(J)(1) Proceeds of an issue are described in this subparagraph if

(i) the issue is issued on behalf of a university for which the founding grant was signed on November 11, 1885, and

(ii) such proceeds are to be used for a Near West Campus Redevelopment Project; a Student Housing Project; renovation, repair, construction, reconstruction or acquisition undertaken or made as a result of an earthquake; and/or seismic bracing.

The aggregate face amount of bonds to which this subparagraph applies shall not exceed $105,000,000.

(B) Bonds the proceeds of which are to be used for the purposes specified in clause (ii) of subparagraph (J)(1) of paragraph (33) of Section 1317 of the Tax Reform Act of 1986 as amended in (A) hereof shall be deemed to comply with the provisions of Section 147(f) of the Internal Revenue Code.

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* There are two subparagraph (J)s in paragraph (33) of Section 1317. The subparagraph (J) being amended pursuant to (A) above is the subparagraph (J) immediately following subparagraph (I).

National Association
of Independent
Colleges and Universities

July 13, 1993

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The undersigned organizations appreciate the opportunity to submit this statement in conjunction with the hearings held by the Subcommittee on Select Revenue Measures on miscellaneous tax proposals. We are writing in support of H.R. 2022, legislation introduced by Representative Robert T. Matsui (D-Calif.). This legislation would make several modifications to the rules governing qualified section 501(c)(3) bonds.

The organizations listed below represent a diverse group of institutions of higher education, ranging from small liberal arts colleges to research universities. All of these institutions are deeply concerned about the ability of colleges and universities to utilize tax-exempt financing to carry out their educational mission.

Tax-exempt bonds are utilized by hundreds of colleges and universities, both public and private, for a wide variety of purposes: construction and renovation of facilities, such as libraries, academic buildings, and dormitories; major equipment purchases for modernization and research; and public safety projects, such as renovation of electrical and fire detection and prevention systems, as well as modifications to provide access to the handicapped.

The Tax Reform Act of 1986 saw the rules governing tax-exempt bond revised—and new restrictions enacted—to a degree never before or since contemplated. Two of these changes have had harmful effects on independent colleges and universities: 1) the characterization of bonds for these institutions as "private activity" bonds; and 2) the $150 million per institution limit on non-hospital qualified 501(c)(3) bonds. In both these cases, we respectfully urge the subcommittee to reverse these two decisions because they seriously erode the ability of nonprofit institutions to address their pressing capital requirements.

From enactment of the income tax until 1986, bonds for nonprofit organizations described in section 501(c)(3) of the Internal Revenue Code generally were treated the same as bonds used directly by state and local governments. In tax-exempt bond parlance, governments and section 501(c)(3) organizations were classified as "exempt persons." The 1986 Act redrew the line between section 501(c)(3) organizations and private businesses that receive tax-exempt financing for property used in their profit-making activities. Section 501(c)(3) organizations are now treated the same as profit-making ventures, i.e., like private businesses. As a matter of principal—not of finance—we strongly object to this classification. Section 501(c)(3) organizations are private in their lack of direct government operation and funding, but they are not private businesses. Tax-exempt bonds provide funds to our nonprofit colleges and universities for the execution of clear and essential public purposes. Colleges and universities utilize tax-exempt bonds for traditional kinds of public purposes which the Internal Revenue Code requires as a precondition to tax-exempt status. In fact, one rationale for tax-exempt status is that the institution serve public, not private, purposes, and carry burdens that the government would otherwise bear.

The second important element is a direct financial restriction on independent colleges and universities imposed by the 1986 Act—the $150 million per institution limit on non-hospital qualified 501(c)(3) bonds. The $150 million limit effectively precludes a number of independent colleges and universities from utilizing tax-exempt financing to finance their capital projects—classrooms, libraries, research laboratories, and dormitories.

We urge the subcommittee and the Congress to repeal this $150 million limit for two reasons. The first is the compelling facilities needs of independent colleges and universities. A recent report by the National Science Foundation maintains that for each $1.00 spent to maintain research facilities, an additional $3.50 was deferred, and that for every $1.00 spent for new science facilities, $4.25 was deferred. Of all capital expenditures undertaken by independent colleges and universities, repair and renovation work is most dependent on debt financing.

The second reason we urge repeal of the $150 million limit is that it unfairly singles out independent colleges and universities, and is premised on a misunderstanding of the role of these institutions. Until 1986, section 501(c)(3) organizations were granted access to tax-exempt bond financing in recognition of the core public services they perform. Independent colleges and universities serve identical functions and provide similar services as the governmentally-funded institutions of higher education. Indeed, it has been estimated that if the state system of higher education were to assume responsibility for educating students attending independent institutions, the additional burden for taxpayers would exceed $12 billion.

It is important to recognize that other changes made by the 1986 Act make the $150 million limit unnecessary. The 1986 Act included a number of modifications to the tax-exempt bond rules for section 501(c)(3) organizations, including arbitrage rebate requirements, as well as bond maturity, hedge bond, and advance refunding restrictions. These changes, as well as the public approval requirements enacted in the Tax Equity and Fiscal Responsibility Act of 1982, render the $150 million limit obsolete.

Determining eligibility for tax-exempt financing by the amount of debt outstanding or by the size of the institution's endowment represents a misunderstanding of the institutions involved and the use of their endowment assets. The amount of debt outstanding for each of these institutions is a direct result of the size and complexity of the institution. The endowments of independent colleges and universities provide a financial base for long-term operation, a base not unlike the annual appropriations received by their state and local counterparts. Further, more than 65 percent of college and university endowment funds are restricted by donors as to how the income derived therefrom may be spent.

Mr. Chairman, members of the subcommittee, the colleges and universities of this nation provide one of the chief means by which this nation has prospered. They attempt to offer the highest quality of education possible. If they are unable to provide adequate facilities and financing of higher education, they cannot maintain that level of excellence. We urge you to approve H.R. 2022.

Respectfully,

Richard F. Rosser

Richard F. Rosser
President

This statement is submitted on behalf of:

American Council on Education
Association of American Universities
National Association of Independent Colleges and Universities
National Association of State Universities and Land Grant Colleges

TESTIMONY OF
JOSEPH M. SUGGS JR
TREASURER
STATE OF CONNECTICUT

REGARDING
ITEM 15 ON PAGE 8 UNDER TAX EXEMPT BONDING
FROM THE JUNE 2, 1993 PRESS RELEASE
BY
THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
THE WAYS AND MEANS COMMITTEE
UNITED STATES HOUSE OF REPRESENTATIVES

This testimony is in support of a legislative correction of a problem concerning rebate of arbitrage earnings on tax-exempt bonds. It involves the applicability of the rebate requirement to bond issues for which all proceeds were expended within six months, except for those proceeds which established a debt service reserve fund.

The Tax Reform Act of 1986 permitted an exception to arbitrage rebate on a bond issue if all the proceeds of the issue were expended within six months of closing. The Act did not address whether or how the "six month exception" could be applied to a bond issue which spent all the construction funds within six months, but included a debt service reserve which was to remain unexpended, except for emergencies, until the final bonds matured.

When the first set of arbitrage rebate regulations was issued by the IRS on May 15, 1989, the preamble enumerated a series of issues to be covered by further regulations at a later date. Language on page 20789 of the Federal Register of May 15, 1989, read as follows:

> First, special rules are necessary to enable issuers that do not issue bonds earlier than 6 months before the proceeds are needed to finance expenditures to qualify for the six-month exception. For example, some bonds may not be marketable without a debt service reserve fund. The regulations will clarify that the 6-month exception is available to issuers of these bonds. Only the earnings attributable to the reserve fund will be subject to rebate if the issue otherwise qualifies....

Before implementing regulations were issued, the Budget Reconciliation Act of 1989 addressed the issue by explicitly permitting the six-month exception to the rebate requirements to be applied to bond issues which have a debt service reserve. If the rest of the proceeds are spent within six months, arbitrage rebate applies only to the debt service reserve. However, the provisions of the Reconciliation Act apply only to bond issues closed after the effective date of the Act in December 1989.

Although the relaxation of arbitrage rebate requirements included in the Budget Reconciliation Act of 1989 was very welcome, the Act effectively prevented the IRS from applying the regulatory correction indicated above to bond issues closed after the effective date of the Tax Reform Act of 1986 and before the effective date of the Budget Reconciliation Act of 1989. The definitive 1989 effective date precluded correction through regulation for prior bond issues.

The State of Connecticut closed seven special tax obligation bond issues with debt service reserve funds between those two effective dates. For all seven, the proceeds, less the debt service reserve, were fully expended within six months of closing. These issues financed portions of the Ten-Year Transportation Infrastructure Renewal Program.

The proposed legislation would permit the six-month rebate exception apply to those seven bond issues. But for the existence of a debt service reserve fund which was required to comply with a pre-existing indenture, the State of Connecticut met all other requirements for use of the the six-month rebate exception.

Testimony of Mr. Peter W. Barca on A Certain Proposal Relating to the Tax Reform Act of 1986: Technical Correction Permitting Kenosha, Wisconsin to Issue Tax Exempt Bonds

Mr. Barca: I want to thank the chairman and the committee members for their time. My name is Peter Barca and I represent the First Congressional District of Wisconsin, which includes the Kenosha area. I have also represented the city of Kenosha in the state legislature for the past eight years, and I know firsthand of the need for the Kenosha redevelopment project, which is the reason I am here today.

I want to make it clear that I am not asking for any special treatment for the city of Kenosha. I am only asking that they be treated in a fair manner, and receive the exemption which was intended by Congress in the Tax Reform Act of 1986.

The city of Kenosha has been planning since the early 1980's to undertake a major downtown redevelopment. The city was unable to move forward with the project due to a delay in clean-up by a federal agency. The city received a transition waiver, but was not allowed to implement the redevelopment program because of a technical drafting error in the legislation.

Once again the city of Kenosha is asking Congress to rectify this condition. I think this proposal merits your support for several reasons.

First, this language is crucial to the city's ability to go forward with their redevelopment project. They have been unable to proceed with this project, due to the technical errors in the Tax Reform Act of 1986. The Kenosha program is key to job creation and revitalization of the Kenosha area offsetting the closing of the American Motors plant in 1988.

Second, this is not a revenue-losing preferential tax treatment item. This language would merely correct a 1986 drafting error at no cost to the federal government.

Third, it seems that the city of Kenosha is due this correction based on two factors: the inability of the Army Corps of Engineers to complete the filling of a "Confined Disposal Facility" (CDF) project in a timely fashion was the first and most serious impediment to the city undertaking this project; the city would have been able to pursue their redevelopment efforts had it not been for a technical error in the Tax Reform Act of 1986.

The reason I am testifying today is to correct an unjust situation. Had it not been for the failure of a federal agency to meet its obligations in a timely manner, there would be no need for this legislation. The Army Corps of Engineers had pledged to fill in a CDF on schedule in 1984. This CDF is the central part of Kenosha's redevelopment project. Had the Corps completed their work on time, the city of Kenosha would have been able to pursue its redevelopment project under existing federal laws.

However, since the Corps delayed completion of this project to, it was necessary for the city to obtain a transitional rule under the Tax Reform Act of 1986. This measure would have allowed the city to pursue its redevelopment project, however, as drafted by the Senate, the rule contained a technical flaw: description of the boundaries were too general and the dates for bond issuance and placed in service were wrong.

If these technical flaws had been corrected, the 1986 provisions would have allowed the following benefits: issuance of $105 million of qualified redevelopment bonds, full Accelerated Cost Recovery System (ACRS) benefits, full investment tax credit benefits, no volume cap requirement, capacity for blind pooling of bonds, bank qualified bonds, no arbitrage restriction, issuance deadline date of December 31, 1996, and placed in service deadline date of December 31, 1999.

Some of these technical flaws were corrected in the Technical Corrections Act of 1988. Boundaries for the Kenosha project were clarified, yet the issue of deadlines was still not addressed. The language also further restricted bonds to conditions existing had bonds been issued the day prior to the Tax Reform Act of 1986. The Language also made use of depreciation deduction and investment tax credit very difficult.

In 1987 the House Ways and Means Committee and full House included Kenosha in the technical corrections provision of the Budget Reconciliation Bill. Unfortunately, the Senate Finance Committee conferees insisted all technical corrections be stripped from the bill. Once again the city of Kenosha received no relief for a problem that was originally the fault of a federal agency they had no control over.

In 1989 the House again approved technical corrections for Kenosha, the same language as in 1987. Once again the Senate Finance Committee would not reopen the 1986 Transition Rule and Kenosha received no relief. The Senate did, however, originate a technical correction rule which directly benefitted a single company (Lady Baltimore Foods, Inc., a Kansas-based business) as part of the Omnibus Budget Reconciliation Act of 1989. Since the Senate saw fit to benefit one company, I believe perhaps they would be willing to give Kenosha rectification for the technical error in their situation.

Once again Congress has a chance to help a community that is in great need of its assistance. The situation in the Senate is not the same today as it has been. The city of Kenosha is ready to proceed with this project. But they can not do so without your help. I'm asking for your full support of this program.

Thanks again Mr. Chairman and members of the committee for your time. If you require any additional information, I would be happy to supply you with any relevant material.

Gerald D. Kleczka

Testimony of Mr. Gerald D. Kleczka on A Certain Proposal Relating to the Tax Reform Act of 1986: Technical Correction permitting Kenosha, Wisconsin to Issue Tax Exempt Bonds

Mr. Kleczka: Today, I am testifying in support of my proposal which corrects a technical error in the Internal Revenue Code. This technical correction will allow the City of Kenosha, Wisconsin to issue qualified tax exempt bonds.

Before explaining the substantive provisions of my proposal, I want to describe the nature of Kenosha's downtown development project. The project will provide much needed economic development to an area reeling from the closing of an auto production plant which cost Kenosha approximately 5,000 jobs. By providing the public infrastructure necessary to attract private investment, the downtown area as well as that of the lakefront will be developed. The development, in turn, will result in needed jobs thus generating federal revenue. In sum, an entire portion of Kenosha as well as the federal government stands to benefit from allowing Kenosha to issue tax exempt bonds.

Despite the importance of the above project to Kenosha and its people, the rehabilitation cannot take place unless a technical correction is made to the Tax Reform Act of 1986 (1986 Act). The needed modification stems not from any action on the part of Kenosha, but from a delay in the completion of a project by the United States Army Corps of Engineers.

In order to best understand the need for the amendment, some history of the problem is necessary. In 1974, Kenosha executed a 10 year contract with the Army Corps of Engineers (Corps). The contract required the Corps to construct and fill a 30 acre Confined Disposal Facility (CDF) to be used as part of the development project. Relying on this contract, Kenosha began detailed planning of the project during 1980 to 1985.

In 1985, the Corps advised Kenosha that completion of the CDF would take until the year 2007. After intense negotiations, this time table was revised to 1996. Aware of the pending changes in the federal tax law regarding municipal bonds, Kenosha requested transitional relief for the project. Kenosha was in the same position as 120 other municipal entities which started redevelopment projects under one set of federal laws, only to have the laws changed after work began on their projects. As a consequence, many of these 120 cases secured the necessary transitional provisions to facilitate successful completion of their projects.

On August 16, 1986, the 1986 Act was enacted, and it included the Kenosha transition rule. Unfortunately, the rule, as drafted by the Senate, was technically flawed. Specifically, the description of the boundaries were too general and the dates for bond issuance and the placed in service requirements were incorrect.

The Technical Corrections Act of 1988 (1988 Act) attempted to remedy the above errors. It clarified the boundaries for the project, but unfortunately, it did not address the other problem related to deadline dates. Additionally, the language of the 1988 Act complicated the situation by restricting the issuance of bonds to conditions existing the day prior to the enactment of the 1986 Act. It also made use of the depreciation deduction and investment tax credit extremely difficult.

In 1987, the House Committee on Ways and Means, along with the full House, included the Kenosha corrections in a technical corrections provision of the Budget Reconciliation Bill. However, the White House and the Senate Finance Committee conferees insisted all technical corrections be stripped from the

In 1989, the House again approved the needed technical correction for Kenosha using precisely the same language approved in 1987. However, the Senate Finance Committee refused to reopen this issue, and once again, Kenosha was denied its relief in the Omnibus Budget Reconciliation Act of 1989.

My proposal provides Kenosha with its desperately needed relief. It focuses on four distinct elements: (1) the description of the eligible project would be corrected; (2) the availability of certain depreciation rules would be extended until September 8, 1999; (3) the availability of certain bond rules would be extended until September 8, 1996; and (4) the issuance of pooled bonds under this proposal would be allowed. These modifications would allow Kenosha to complete its bond offering and permit the restoration of a blighted area. I urge its passage.

Statement of
Larry Hobart, Executive Director
American Public Power Association
Before the
Committee on Ways and Means
Subcommittee on Select Revenue Measures

July 13, 1993

Mr. Chairman and distinguished members of the Subcommittee, my name is Larry Hobart and I am the executive director of the American Public Power Association (APPA). I am submitting this statement for the hearing record on behalf of 1,750 local, publicly owned electric utilities throughout the United States. Collectively, public power systems provide electric service to one out of every seven Americans.

The focus of this statement is H.R. 1938, a bill introduced by Representative Richard Neal (D-MA) and cosponsored by 13 members of the House Ways and Means Committee. Representative Neal's bill would remove the $15 million private use restriction placed solely on public power bonds. The legislation would eliminate a discriminatory provision included in the 1986 Tax Reform Act that causes public power systems to operate inefficiently, further complicates the tax code, and treats output facilities more harshly than other governmental facilities. (The Neal bill does not address a 1987 provision included in the Omnibus Budget Reconciliation Act [P.L. 100-203] restricting the use of municipal bonds to acquire private output facilities).

Historically, state and local governments and other public entities have relied on the issuance of municipal tax-free bonds to finance a wide range of essential public facilities, including schools, roads, water and wastewater treatment systems, electric and gas utilities, hospitals, health centers, prisons and public transit.

In 1986 Congress passed the Tax Reform Act, which included numerous provisions restricting the use of tax-exempt bonds. This action was motivated by two factors: 1) curbing perceived abuses by the bond community; and 2) increasing revenue to reduce the federal budget deficit.

One of several major changes made in 1986 was the extent to which private parties could benefit from the use of facilities constructed by tax-exempt bonds. Pre-1986, up to 25 percent of the output from facilities constructed by tax-exempt bonds could be used by private parties. This restriction was reduced to 10 percent for all government bonds. However, for public power (and public natural gas) facilities, a further limitation was imposed -- the public power private-use test was **the lesser of** 10 percent or $15 million.

Why Is The $15 Million Private Use Restriction Unfair?

There are neither fiscal nor public policy justifications for the $15 million private-use test imposed only on public power. While limiting private use of publicly financed facilities from 25 percent to some lower amount was the subject of debate, this separate limitation was never explicitly considered. The limitation was not imposed for fiscal reasons since no revenue estimates were ever prepared. The impact on the U.S. Treasury, if any, is unknown.

In 1989 the Anthony Commission on Public Finance, chaired by former Rep. Beryl Anthony (D-AR), issued a report entitled ''Preserving the Federal-State-Local Partnership: The Role of Tax-Exempt Financing.'' The Commission observed that ''there is no public policy reason to apply the private use restriction differently for different types of facilities....[T]o limit the private use portion of bonds issued to finance public power and other output facilities appears to be totally without merit.''

The restriction affects any public power project with construction costs in excess of $150 million. Electric utility generation and transmission facilities are capital intensive -- many costing in excess of $500 million. For such projects the effective private-use limit may be 2 to 3 percent or less, not the 10 percent allowed for all other governmental facilities.

The restriction imposes operational problems and inefficiencies. Generating facilities have long construction lead times and have useful lives of 30 years or more. They are sized to meet anticipated future power supply requirements, not the power supply requirements that exist at the time of construction or the time they are first brought into service. These facilities are designed to have the ability to generate more electricity than initially needed by the public power developer.

Of course, this surplus capacity can sit idle until it is needed by the public power system. However, it clearly makes sense, both economically and environmentally, to utilize that capacity by selling it to others in the early years. But because of the special $15 million limit imposed on public power, sales are restricted to de minimus amounts of electricity. Thus the plants may not be operated at maximum efficiency levels. Moreover, there are other ramifications as well, such as obliging investor-owned utilities to build more power plants rather than purchasing available power from existing public power generators.

On June 22, 1993, the U.S. Department of Treasury testified before your Subcommittee on this issue as well. Leslie B. Samuels, Assistant Secretary for Tax Policy said, "There does not appear to be any reason to treat output facilities more harshly than other facilities. As a practical matter, the $15 million output limit ... create[s] an incentive for public power to operate inefficiently."

For example, the Lower Colorado River Authority (LCRA) has indicated that the $15 million private use restriction has limited its ability to enter into certain innovative financing and joint-venture opportunities. The operational requirements of owning and operating natural gas assets by definition has raised issues in the private use arena. Because natural gas not required for generation is sold to third parties, compliance with the private use rules in this case creates deleterious economic results.

The Florida Municipal Power Agency has been precluded on a number of occasions from entering into joint ventures with privately owned cogeneration facilities as a result of the $15 million private use restriction.

The private use restriction could lead to conflicts between federal laws. For example, the Energy Policy Act of 1992 gives the Federal Energy Regulatory Commission clear authority to order any utility to provide transmission service. If a public power utility were ordered by FERC to provide transmission services with a value exceeding $15 million over power lines financed through municipal bonds, the utility could face a Hobson's choice. On one hand, by refusing to provide the transmission service, the utility would be in violation of the Federal Power Act. On the other hand, if it complies with the FERC order, would it be in violation of the 1986 Tax Reform Act?

It is noteworthy that facilities other than power generating facilities are affected by this restriction. In urging the Clinton-Gore transition team to eliminate this artificial limit, the State of New York noted that it ''precludes public power authorities from financing retrofitting and other demand-side management programs that conserve energy. Tax-exempt bonding is particularly appropriate for such projects because they require a capital expenditure upfront to save energy costs over time.''

Conclusion

Private-use restrictions limiting the benefits available to private parties from publicly financed facilities are based on fiscal and public policy considerations. However, the restrictions should apply equally to all governmentally financed and operated facilities.

The special and discriminatory $15 million private-use restriction that applies only to publicly owned electric and gas facilities is not supported by any public policy justification. It discriminates against communities that elect to provide their electric and gas utility services. It may force developers of electricity generation and transmission facilities to forego the most economic use of those facilities, particularly in the early years of their service. I urge the Committee to approve Congressman Neal's bill, H.R. 1938, and to move the measure as expeditiously as possible.

Testimony of the
Edison Electric Institute
Regarding H.R. 1938

Before the

Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

July 12, 1993

The Edison Electric Institute (EEI) appreciates this opportunity to provide written comments to present our views on H.R. 1938 which was introduced on April 29, 1993. H.R. 1938 is a proposal to repeal the $15 million limitation on the amount of a tax-exempt bond financing which may be used for an output facility. This bill was listed in the June 2, 1993 announcement of a public hearing, on miscellaneous revenue issues, by the Honorable Charles B. Rangel, Chairman of this Sub-Committee.

EEI is the association of electric utility companies. Our members serve 99 percent of all customers served by the investor-owned segment of the industry. We generate approximately 78 percent of all electricity in the country and provide electric service to 76 percent of all ultimate electricity customers in the Nation.

EEI opposes the adoption of H.R. 1938. In addition to the competitive advantage it would provide government-owned utilities, it would create an inefficient allocation of capital; cause an increase in the cost of financing traditional governmental activities; provide higher-income persons with an increased opportunity to avoid taxes by means of tax-exempt investments; and cause revenue losses to the Federal treasury.

Background

Section 141, including subsection (b), was added to the Internal Revenue Code (Code) in 1986 as part of a complete overhaul of the tax-exempt financing area. In the General Explanation of the Tax Reform Act of 1986 (1986 Blue Book), prepared by the Staff of the Joint Committee on Taxation, the purpose of the overhaul of tax-exempt financing is described, beginning on page 1151.

> Congress was concerned with the large and increasing volume of tax-exempt bonds being issued under prior law. The effects of this increasing volume included an inefficient allocation of capital; an increase in the cost of financing traditional governmental activities; the ability of higher-income persons to avoid taxes by means of tax-exempt investments; and mounting revenue losses.
>
> At the same time, Congress recognized the important cost savings that tax-exempt financing could provide for State and local governments, in a period marked by reductions in direct Federal expenditures for such purposes. To the extent possible, Congress desired to restrict tax-exempt financing for private activities without affecting the ability of State and local governments to issue bonds for traditional governmental purposes.
>
> Between 1975 and 1985, the volume of long-term tax-exempt obligations for private activities (including tax-exempt IDBs, student loan bonds, mortgage revenue bonds, and bonds for use by certain nonprofit charitable

organizations) increased from $8.9 billion to $116.4 billion. As a share of total State and local government borrowing, financing for these activities increased from 29 percent to 53 percent. Essentially, these bonds provided an indirect Federal subsidy to private activities. This affected the efficiency and equity of the tax system in several ways.

First, the large volume of nongovernmental tax-exempt bonds increased the interest rates that State and local governments were required to pay to finance their activities. As the total volume of tax-exempt bonds increases, the interest rate on the bonds must increase to attract investment from competing sources. The additional bond volume caused by nongovernmental use thus increased the cost of financing essential government services.

Second, tax-exempt financing for certain activities of nongovernmental persons resulted in a misallocation of capital. Efficient allocation of capital requires that the return from a marginal unit of investment be equal across activities. This can result, in turn, only if there is no preferential treatment for investment in certain activities. By restricting the ability of nongovernmental activities to qualify for tax-exempt financing, the Act reduces preferential treatment for certain activities and allows capital to be allocated more efficiently.

Third, the equity of the tax system was harmed as high-income taxpayers and corporations limited their tax liability by investing in tax-exempt securities. Because of the large volume of nongovernmental tax-exempt obligations, tax-exempt yields were often close to taxable yields. Taxpayers with high marginal tax rates accordingly received an after-tax yield on tax-exempt bonds significantly higher than the yield they would have received from taxable investments. A perception of inequity arises when such investors are able to reduce their tax liability and still receive a rate of return nearly as high as that on taxable investments.

Finally, rapid growth in the issuance of nongovernmental tax-exempt bonds resulted in mounting revenue losses.

Another important factor affecting the tax-exempt status of financing private activities is the Energy Policy Act of 1992 (the Energy Policy Act) which provided for expanded access to transmission facilities and the development of exempt wholesale electricity generators. These provisions in the Energy Policy Act, as part of the policy on electric energy, were intended to create a competitive market for wholesale power generation. Tax-exempt financing alters the competitive balance created in the Energy Policy Act. The Energy Policy Act was intended to establish energy policy for the Nation by encouraging conservation and renewable resources while establishing a level playing field for energy suppliers.

Summary of H.R 1938

The bill would repeal the $15 million private-use limitation on public power bonds. This limitation provides that if 5 percent or more of the proceeds of a bond issue are used with respect to an output facility (such as electric or gas generation, transmission and related properties), the issue is considered a private activity bond, and the interest thereon generally is not tax-exempt, if more than $15 million of the financing is used by nongovernmental persons on a basis other than as a member of the general public. The repeal would be accomplished by amending section 141(b) of the Code by striking paragraph (4) and redesignating the remainder of the paragraphs.

Discussion

Current tax law does not restrict the financing of traditional and essential governmental activities. Restrictions are included in the Code only on those activities which are deemed to benefit private individuals or companies. The 1986 Blue Book expressed the concern of Congress that a significant amount of bond proceeds from governmental issues was being used to finance private activities not specifically authorized to receive tax-exempt financing. The $15 million limitation is a restriction on just such an activity because it only limits sales by government-owned utilities to private users outside their service territory. For that reason, the restriction provides a reasonable limitation on private use of tax-exempt financing and should be retained.

Current restrictions on the use of tax-exempt financing for output facilities contain both a 10 percent bond issue limitation and a $15 million project limitation. The dual restriction was designed to prevent the use of multiple financing schemes to subsidize private activities with tax-exempt financing. This provided government-owned utilities with the ability to finance projects for general public use, while limiting the flexibility to subsidize projects operating for private purposes in competition with tax-paying entities. The restrictions imposed by Congress were carefully designed with specific purposes in mind as discussed in the 1986 Blue Book. Nothing has changed which would justify removing these restrictions. In fact, the Energy Policy Act, which provided expanded access to transmission facilities and increased competition in the wholesale power generation market, actually provided additional reasons to retain or strengthen these restrictions.

The repeal of the $15 million restriction would provide government-owned utilities with a competitive advantage in the form of additional tax subsidies over investor-owned utilities on sales to private users outside the service territory of the government-owned utility. Currently, government-owned utilities receive significant tax subsidies from Federal, state and local sources. In addition to paying no income tax on their business operations, government-owned utilities receive excise tax benefits (for example, exemption from highway-use tax) and tax-exempt financing benefits which are subsidized by the tax paying public. Many government-owned utilities pay little or nothing in the way of property and other types of state and local taxes. By contrast, an investor-owned utility pays income tax (approximately 24 percent of pre-tax book income in 1991) and Federal excise taxes in addition to providing taxable income to investors in the form of interest and dividends. Investor-owned utilities are the only form of utility ownership to pay all of these taxes. Investor-owned utilities, as good corporate citizens, recognize the responsibility to provide for essential governmental services. However, investor-owned utilities do not believe that the government, in essence all taxpayers, should subsidize those with whom we compete. In particular, we do not believe that a municipal utility should be subsidized to compete in the service territory of an investor-owned utility.

In addition to providing a competitive advantage to government-owned utilities, the removal of the $15 million restriction would create revenue losses for the Federal government further exacerbating the Federal budget deficit.

In the 1986 Blue Book, the Staff of the Joint Committee also cited the increased cost to local government of the higher interest rates caused by the increased volume of tax-exempt financings. There is greater pressure on State and local government budgets today than there was in 1986. This has been caused by several reasons; however, it is important for Congress not to increase the cost of financing essential government services by providing tax-exempt financing for selective new and additional private uses.

EEI believes that, if H.R.1938 is enacted, the competitive position of tax-paying entities will be further eroded, thus, reducing the Federal tax base. Investor-owned utilities, and their bondholders and shareholders, paid over $100 billion in Federal income taxes during the period 1986 through 1991. By contrast, government-owned utilities, and their bondholders, were generally exempt from all Federal taxes. This disparate advantage for government-owned utilities not only results in unfair competition, but if expanded, could further increase the Federal budget deficit by directly or indirectly subsidizing private activities. With the tremendous national concern about the deficit, we do not believe it comports with our Nation's economic and tax policy to enact legislation that would add to that deficit.

Finally, the Federal subsidy provided through the elimination of the $15 million restriction may well encourage the construction of projects which may not otherwise be built. The ability of government-owned utilities to sell output to private entities effectively allows the government-owned utility to arbitrage profit from such sales. The result is that projects that would otherwise be uneconomic may be built. These projects could take the form of dams, generating plants, or other projects designed to increase production rather than conservation.

Conclusion

EEI opposes the adoption of H.R. 1938. In addition to the competitive advantage it would provide government-owned utilities, it would create an inefficient allocation of capital; cause an increase in the cost of financing traditional governmental activities; provide higher-income persons with an increased opportunity to avoid taxes by means of tax-exempt investments; and cause revenue losses to the Federal treasury.

Statement of the Massachusetts Municipal Wholesale Electric Company

for the Record of
U.S. House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures

Regarding H.R. 1938,
A Bill to Eliminate the $15 Million Private-Use Restriction
Placed Solely on Public Power Bonds

July 15, 1993

Background

The Massachusetts Municipal Wholesale Electric Company (MMWEC), founded by a group of municipal systems in 1969, is the recognized joint action agency for Massachusetts municipal utilities, providing a broad range of power supply, financial, and other utility services. Today, MMWEC represents 29 of 40 municipal systems in Massachusetts, providing more than 1,000 megawatts of power to half a million customers across the state. MMWEC employees 125 people and represents nearly $300 million dollars in annual revenues.

In 1976, MMWEC became a public corporation, and as such, is authorized to issue tax exempt revenue bonds to finance electric power projects, the output of which is sold at cost to MMWEC's member and participant utilities. Since 1976, MMWEC has issued a total of $2,857,815 in tax-exempt bonds, $262 million of which were used for construction of MMWEC's 520 megawatt Stony Brook power plant, built in 1981.

The $15 Million Private Use Restriction

The Tax Reform Act of 1986 lowered the private use test applicable to tax-exempt bonds from 25% to 10%. However, a separate limit was imposed on public power. Section 141(b)(4) of the tax code provides that the private use test for public power "output" facilities is to be the lesser of 10% or $15 million. Exceeding this amount of private use results in the loss of tax exempt status of the bonds issued for such facilities.

No rationale or justification was provided for this discriminatory treatment and no hearings were on this separate rule were held. MMWEC sees no public policy, public interest or financial justification for this rule.

The Result

The restriction:

(1) Constrains public power entities from building units of a size which would allow them to gain economies of scale.

(2) Hampers the ability of entities such as MMWEC to buy and sell power in the open market, impeding our competitiveness.

(3) Requires public power entities to build smaller units, thereby inhibiting our ability to comply with pollution standards using tax-exempt financing vehicles.

(4) Precludes MMWEC and others from building facilities designed to meet future needs due to the inability to sell off excess capacity in the early years of the plant's life.

The bottom line is that this restriction is not only discriminatory in its application, but that it de facto drives up the cost of power to consumers of public power systems.

Support for H.R. 1938

H.R. 1938, a bill introduced by Representative Richard Neal (D-MA) and co-sponsored by 14 members of the House Ways and Means Committee, would remove the $15 million private use restriction placed solely on public power bonds and see that such facilities are treated in the same manner as other public facilities which are governmentally financed and operated, such as schools, public transit systems, etc.

MMWEC urges the Committee to approve Congressman Neal's bill and to move the measure expeditiously.

Submission of the National Association of Bond Lawyers to the House Ways and Means Committee, Subcommittee on Select Revenue Measures

July 20, 1993

These comments are being submitted by the National Association of Bond Lawyers ("NABL") in response to the request of the Ways and Means Subcommittee on Select Revenue Measures for comments on tax-exempt bond provisions. NABL is a non-profit corporation organized for the purposes of educating its members and others in law relating to state and local bonds and other obligations, providing a forum for the exchange of ideas as to law and practice, improving the state of the art in the field, providing advice and comment at the federal, state and local levels with respect to legislation, regulations, rulings, other actions or proposals affecting state and local obligations, and providing advice and comment with regard to state and municipal obligations in proceedings before courts and administrative bodies through briefs and memoranda as friend of the Court. Currently, NABL has approximately 3,000 members.

Given NABL's particular expertise in the technical aspects of municipal finance law, we restrict our comments to the technical issues relating to legislative proposals. Because the proposals described in the Ways and Means Select Revenue Measures Subcommittee Press Release No. 4, dated June 2, 1993, are conceptual in nature, we will refrain from comment on them, but instead offer the following technical comments on the simplification provisions in H.R.13 related to bonds which are also before the Committee. We commend Chairman Rostenkowski for his leadership in pursuing tax simplification in the municipal bond sections of the Code which are particularly ripe for simplification. We hope his leadership will provide the impetus to enact these simplification proposals.

Section 631 - Repeal of $100,000 Limitation on Unspent Proceeds Under 1 Year Exception from Rebate.

By repealing the $100,000 restriction in section 148(f)(4)(B)(ii)(I), this provision of H.R. 13 significantly simplifies issuers' compliance with the rebate exception and thereby simplifies the overall compliance with the rebate requirements of the arbitrage restrictions of §148.

Section 632 - Exception from Rebate for Earnings on Bona Fide Debt Service Fund Under Construction Bond Rules.

This provision of H.R. 13 amends section 148(f)(4)(c) by adding clause (xvii) to exempt bona fide debt service funds from the rebate requirement if the issuer meets the requirements for expenditure of construction proceeds. This addition allows issuers to disregard earnings in bona fide debt service funds if they are eligible for the 2-year exception from rebate for construction bond issues. This will simplify issuers' tracking and arbitrage compliance requirements.

Section 633 - Aggregation of Issues Rules not to Apply to Tax or Revenue Anticipation Bonds.

This section adds specific language to clarify that governmental and qualified 501(c)(3) bonds issued simultaneously with tax or revenue anticipation bonds issued with the expectation of meeting the requirements of section 148(f)(4)(B)(iii) (the exception from rebate for tax and revenue anticipation notes) shall not be treated as a single issue for purposes of the arbitrage rules. This explicit legislative statement clarifies a situation over which practitioners have taken differing views. This direct statement resolves that divergence of opinion and is therefore helpful.

Section 634 - Repeal of Disproportionate Private Business Use Test.

This section strikes paragraph (3) of section 141(b), the "disproportionate private business use test". The "disproportionate governmental use" concept has been unclear since its creation in 1986. Its elimination will simplify issuers' analysis of their use of bond proceeds for purposes of complying with the private use test and is a significant improvement in the law.

Section 635 - Expanded Exception from Rebate for Issuers Issuing $10 Million or Less of Bonds.

This section increases the $5 million limit to $10 million for the exception from rebate for small issuers of bonds. This is a significant simplification for small issuers who will no longer have to track earnings for compliance with the arbitrage rebate requirement.

Section 636 - Repeal of Debt Service Based Limitation on Investment in Certain Non-Purpose Investments.

This section repeals the limitation on investment in non-purpose investments for private activity bonds. Eliminating this limitation will alleviate arbitrage tracking problems for reserve funds for private activity bonds and will therefore simplify issuers' compliance.

Section 638 - Clarification of Investment-Type Property.

This section provides legislative history for the definition of "investment-type property." This provision and its legislative history were included in H.R. 11. While we agree with the goal of clarifying the definition to cover trade discounts, we have the following concerns regarding the legislative history proposed in H.R. 11.

Reasons for Proposed Legislative History

H.R. 11, §4638, as passed by Congress and vetoed by the President last year, would have deleted and reinserted the phrase "investment-type property" in section 148(b)(2)(D) of the Internal Revenue Code. The legislative history is intended to permit state and local governments to realize trade discounts when they purchase goods and services, without adversely affecting the tax-exempt status of bonds issued to finance the goods and services. Unfortunately, the legislative history included in the Ways and Means Committee Report of H.R. 11 left unintended implications that would have narrowed existing law. It would have prohibited common current governmental practices, if it had been enacted as proposed.

To preserve existing practices and current law, the legislative history used by the Committee on Ways and Means for H.R. 13 to permit trade discounts should be drafted in a manner that does not include unintended implications for existing law. The accompanying draft legislative history should be used for that purpose. It is marked to reflect changes from the language included in the House Report on H.R. 11. The principal changes are intended

- to make clear that prepayments for goods and services are permitted if they are motivated by non-arbitrage business considerations, even when they do not occur so often as to comprise a business custom (see PLR 9142012 issued by the IRS in 1991),[1/]

- to make clear that the language authorizing trade discounts is a "safe harbor" and does not describe the only method for avoiding treatment as an investment, and
- to otherwise preserve the legislative history on "investment-type property" that accompanied the Tax Reform Act of 1986.

The Committee Report description should read as follows:

Present Law

Interest on State and local government bonds is not tax-exempt if the bonds are arbitrage bonds. A bond generally is an arbitrage bond if the proceeds are invested in materially higher yielding "investment-type property," other than during prescribed temporary periods or as a part of a reasonably required reserve or replacement fund. Additionally, all profits earned on investment of bond proceeds other than for the governmental purpose of the borrowing generally must be rebated to the Federal Government.

If issuers of tax-exempt bonds prepay amounts for activities being financed with the bonds, arbitrage profits may be indirectly earned and retained by the issuers. Therefore, present law provides that property or services acquired pursuant to ~~most~~ transactions involving prepayments ~~is~~ **may be** investment-type property, and ~~is~~ **so** subject to either yield restriction or arbitrage rebate requirement**, if entered into for investment purposes. It has been unclear whether acquisition contracts involving standard trade discounts are "investment-type property"**.

Explanation of Provision

The bill deletes and reinserts the term "investment-type property" in the Code arbitrage restrictions. This amendment is intended to clarify Congress' original intent as to the meaning of that term. Absent restrictions, issuers might use bond proceeds to prepay items in such a manner that the tax-exempt bond arbitrage restrictions would be avoided and the issuers would retain the economic benefit of arbitrage profits. The expansion of property subject to the Code arbitrage restrictions to include all "investment-type property" was intended to preclude such arrangements.

As was stated in the legislative history accompanying the Tax Reform Act of 1986 (the "1986 Act"), however, ~~in certain circumstances~~, **not all** advance payments for property or services **are** ~~may be made because of non~~ arbitrage-motivated ~~business customs~~. For example, a governmental unit may decide to purchase property (e.g., a government office building or equipment) with an accompanying bond-financed up-front payment rather than lease the property without such an initial debt issuance. It is ~~not~~ intended that the fact that an issuer purchases, rather than leases, property should ~~necessarily~~ **not generally** be construed as giving rise to investment-type property.

Similarly, certain services (e.g., bond insurance for the entire term of the bonds) may be available only in exchange for a lump-sum payment made in advance, or the credit standing of an

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[1/] This clarification is also consistent with the definition of investment-type property included in the recently-adopted final arbitrage regulations (Treas. Reg. §1.148-1(b)).

issue may be such that vendors will not supply property or services before receiving payment. As was indicated in 1986, the term investment-type property is not intended to include property or services acquired in exchange for debt-financed lump-sum payments, whether or not discounted, that are dictated by independent, non-arbitrage-motivated business ~~customs~~ considerations governing availability of the property or services to all similarly-situated persons (whether or not State or local governmental units).

~~Further, the~~ The amendment is intended to clarify the application of this 1986 Act restriction to certain governmental and section 501(c)(3) organization procurement activities.[2] When States and local governments and section 501(c)(3) organizations purchase property or services for use in carrying out their governmental or exempt activities, they may be offered discounts on the same terms as fully taxable purchasers for prompt or early payment or for volume purchases. Availability of these discounts presents an opportunity for economic arbitrage, and by taking advantage of the discounts, States and local governments and section 501(c)(3) organizations could be viewed as acquiring investment-type property. The committee intends, however, that acquisition at a discounted price of property or services to be used in carrying out a governmental or section 501(c)(3) organization exempt activity should not be treated as the acquisition of investment-type property if--

(a) the trade discount is available on the same terms to all purchasers of the property or services (both governmental, section 501(c)(3) organization, and fully taxable nongovernmental entities);[3] and

(b) the scheduled or actual timing of any early payment or the volume of any purchase by a governmental unit or section 501(c)(3) organization is not substantially different from the comparable timing of payments or volume of purchases by similarly situated fully taxable nongovernmental entities purchasing the same property or services.

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[2] This amendment is intended to address only the treatment of the trade discounts described herein. It is not intended to change or otherwise give rise to any implication as to the proper meaning of the term "investment-type property" in other circumstances. See, e.g., Private Letter Ruling 9142012 (July 17, 1991).

[3] Any trade discount which is structured differently for purchasers eligible to ~~using~~ use taxable and tax-exempt debt or which is set at a level such that beneficiaries of tax-exempt bonds are more likely to take advantage of the discount than fully taxable purchasers (e.g., in a manner related to the tax-exempt borrowing costs of the purchaser) is not intended to qualify as a trade discount that is available on the same terms to all purchasers of the property or services. A transaction including such a trade discount, therefore, typically must be evaluated under the general consideration described above.

The committee recognizes, however, that the ~~implicit discount rate in~~ attractiveness to a vendor of any purchase arrangement involving a lump-sum advance payment is related to the borrowing costs of the vendee, and that ~~therefore,~~ beneficiaries of tax-exempt bonds may benefit economically more from any ~~uniform discount rate~~ such arrangement than comparable taxable borrowers. This fact alone is not to be construed as violating the uniformity requirement, provided the discount rate is uniform for governmental, section 501(c)(3) organization, and fully taxable nongovernmental purchasers and is set at a sufficient level to be taken advantage of generally by purchasers using taxable financing as well as by governmental and section 501(c)(3) organizations benefiting from tax-exempt bonds.

Effective Date

This provision is effective as if included in Title XIII of the Tax Reform Act of 1986.

American Association of Port Authorities

Erik Stromberg
President

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JAIME LOPEZ CAMPOS
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Valparaiso Chile

September 1, 1993

The Honorable Dan Rostenkowski
Chairman
House Ways and Means Committee
1102 Longworth House Office Building
Washington, D.C 20515-6348

The Honorable Charles B. Rangel
Chairman
House Ways and Means Committee
Select Revenue Measures Subcommittee
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Gentlemen:

Please accept this letter for the record of the Wednesday, September 8 hearing on miscellaneous revenue measures. The U.S members of the American Association of Port Authorities (AAPA) strongly supports the amendment to expand the definition of transportation facilities under section 142(c)(2) of the Internal Revenue Code. The proposal would permit the use of tax exempt revenue bonds for access and other key projects necessary for the United States to maintain a seamless, efficient intermodal transportation system.

AAPA members are public entities mandated by law to serve public purposes--primarily the facilitation of waterborne commerce and the consequent generation of local and regional economic growth. As public agencies, AAPA members share the public's interest in serving our country's economic, international trade, and national security objectives. The deep draft commercial ports of our country handle over 95 percent of the nation's international trade. Public ports serve as a vital conduit linking the United States to the world marketplace, a critical intersection in the intermodal chain. Ports serve broad hinterlands, connecting farmers, manufacturers and suppliers often thousands of miles inland to international markets thousands of miles from our shores.

The recently enacted Intermodal Surface Transportation Efficiency Act of 1991 clearly recognizes the national interest in an efficient freight transportation system as a critical factor in our country's ability to compete in the international marketplace and assure competitive prices for U.S. consumers. Exports today are increasingly necessary to the health of America's economy, representing one out of six U.S. manufacturing jobs.

International and domestic waterborne trade creates tremendous positive economic impacts at the local, regional and national levels. In 1991, the most recent year for which data is available, the U.S. DOT estimates that commercial port activities generated 1.5 million jobs, contributed $70 billion to the gross domestic product, provided personal income of $52 billion, generated federal taxes of $14 billion, state and local taxes of $5.3 billion, and $11 billion in Customs receipts. The importance of ports to local, state and regional economies cannot be overstated.

U.S. public ports have spent nearly $12 billion dollars in the last 40 years to develop marine terminal facilities. The U.S. Department of Transportation estimates that they will spend an additional $5.5 billion before the year 2000. In 1991, 1.4 billion tons of foreign and domestic waterborne cargo moved through our nation's ports in 1991, including 938 million short tons of import/export cargo worth $461.8 billion. This represents a 25 percent increase compared to 1985 and almost double the volume of 25 years ago.

However, no matter how productive those marine terminal facilities are, nor how accessible the port is by ship, our national transportation system cannot operate to maximum efficiency if the port is not readily accessible from the landside. The intermodal transportation system can be compared to a pipeline with its overall efficiency determined by the pipeline's most narrow section. With the serious shortfalls in public budgets, public investments must be directed where they're needed most, that is, directed at those narrowest sections which are increasingly the connections to the port. Since the amount of international cargo moving through U.S. ports have been projected to triple by the year 2020, the need for efficient landside access can only increase and must be planned for today.

The proposal would provide national benefits in the form of financing alternatives for critical links in our U.S. transportation system. We strongly encourage the adoption of the proposal.

Respectfully,

Jean C. Godwin

Jean C. Godwin
Vice President,
Government Relations

CHIEF
WASHAKIE

SHOSHONE & ARAPAHO TRIBES
WIND RIVER TAX COMMISSION
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307-332-7835 307-856-9449

CHIEF
BLACK COAL

May 25, 1993

Ms. Janice Mays
Chief Counsel
House Ways & Means Committee
1102 Longworth House Office Building
Washington, D.C. 20515

SUBJECT: *Shoshone And Arapaho Tribes' Joint Business Council Resolution Nos: 7057, 7058, And 7059 Endorsing And Supporting H.R. 478, S. 211 And H.R. 1325 Respectively*

Dear Ms. Mays :

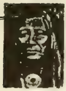
Please find enclosed, copies of the resolutions referenced. Resolution No: 7057 and 7059 support house bills HR 478 and HR 1325, which can provide for economic development on Indian reservations. S 211 is the senate's version of HR 1325. Representatives of the Shoshone and Arapaho Tribes met with other staff members of the Ways & Means Committee in early April to discuss these bills.

We are requesting that Chairman Rostenkowski's staff provide copies of these resolutions to each member of the Committee and support their passage. In addition, we have provided copies to the Joint Tax Committee, both the minority and majority Indian Affairs Committees, as well as the minority and majority Senate Finance Committees.

Thank you for considering this request. Should you have any questions, or if I may be of service, please contact me at one of the numbers listed.

Very truly yours,
Richard L. Ortiz
Richard L. Ortiz
Director

CC: RLO
Legal
JBC



CHIEF WASHAKIE

SHOSHONE & ARAPAHOE TRIBES
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CHIEF BLACK COAL

RESOLUTION
SHOSHONE AND ARAPAHO TRIBES
WIND RIVER INDIAN RESERVATION
FORT WASHAKIE, WYOMING

RESOLUTION NO: 7059
PAGE NO: 1

A RESOLUTION TO SUPPORT AND ENDORSE HOUSE OF REPRESENTATIVES' BILL H.R, 1325 INTRODUCED BY REPRESENTATIVE RICHARDSON THAT AMENDS THE IRS CODE TO ALLOW FOR FEDERAL INCOME TAX CREDITS FOR INDIAN INVESTMENT AND EMPLOYMENT

WHEREAS, The Joint Business Council (JBC) of the Wind River Indian Reservation is the governing body of the Shoshone and Arapaho Tribes; and

WHEREAS, the unemployment rate on the Wind River Indian Reservation averages seventy percent (70%); and

WHEREAS, seventy-five percent (75%) of the Indian population of the Wind River Indian Reservation's income level is at or below the poverty level as established and published by the Office of Management and Budget; and

WHEREAS, the JBC has been lobbying Congress for the last four years to allow federal income tax credits pertaining to taxes paid to Indian Tribes and economic development.

NOW THEREFORE BE IT RESOLVED, that the JBC of the Shoshone and Arapaho Tribes of the Wind River Indian Reservation, hereby endorse House of Representatives Bill H.R. 1325, sponsored by Representative Richardson of New Mexico, a bill to amend the Internal Revenue Service Code to allow a federal income tax credit for Indian Investment and Employment (Copy Attached).

BE IT FURTHER RESOLVED, that the JBC of the Shoshone and Arapaho Tribes of the Wind River Indian Reservation supports federal legislative efforts in the tax area that will generate economic activity on Reservations and that benefits people of the Reservations.

BE IT FINALLY RESOLVED, that the JBC hereby recommends to Congress that it work directly with the Clinton Administration to ensure that the language of this bill be incorporated initially into the Administration's bill under the Indian Enterprise Zone Concept and Indian Empowerment Concept.

RESOLUTION

SHOSHONE AND ARAPAHO TRIBES
RESOLUTION NO: 7059
PAGE 2

CERTIFICATION

WE THE UNDERSIGNED, as Chairmen of the Shoshone and Arapaho Business Councils, hereby certify that in a meeting of a Joint Session, the Shoshone Business Council (SBC) and the Arapaho Business Council (ABC) are composed of six (6) members each, and that five (5) members of the SBC and five (5) members of the ABC, constituting a quorum, were present at a meeting duly and regularly called, noticed, convened and held this sixth (6TH) day of May, 1993, that the foregoing Resolution was adopted by the affirmative vote of five (5) SBC members and five (5) ABC members, Chairmen voting, and the Resolution has not been rescinded or amended in any way.

Done at Fort Washakie, Wyoming this 6TH day of May, 1993.

Chairman, Shoshone Business Council

Chairman, Arapaho Business Council

ATTEST:

Joint Tribal Secretary

TESTIMONY OF ARCTIC SLOPE REGIONAL CORPORATION, GOLDBELT CORPORATION, SEALASKA CORPORATION

Mr. Chairman and Members of the Subcommittee:

Thank you for the opportunity to present our views on the proposal to grant Alaska Native Corporations ("Native Corporations") standing to contest Internal Revenue Service ("IRS") determinations in net operating loss ("NOLs") cases in court. Arctic Slope Regional Corporation, Goldbelt Corporation and Sealaska Corporation join in this statement, having led this effort which will also benefit other Native Corporations. We can also report that we have the full support of the other parties in these complex transactions -- the buyer corporations.

Last year, the Conference Report to H.R. 11, the Revenue Act of 1992, contained a procedural provision of critical importance to Native Corporations which is essentially identical to the one under consideration by this Subcommittee. That provision, Section 7617, granted the Native Corporations standing to contest tax deficiencies in so-called NOL transactions expressly permitted by law. Working with the Department of the Treasury ("DOT"), the IRS, the Joint Committee on Taxation ("JCT"), the House Ways and Means Committee and the Senate Finance Committee, we were able to craft a detailed provision which protected the rights of all of the parties, including the government, and was self-financed for revenue estimating purposes. Moreover, the portion of the Statement of Managers supporting the provision, running six pages in length, covered almost every conceivable nuance not addressed in the legislation itself.

However, because of the President's veto of H.R. 11, this provision failed to become law and the Native Corporations remain without the right to go to court to contest tax liabilities for which they are the true parties in interest.

By way of background, under the Deficit Reduction Act of 1984, Native Corporations were generally permitted to consolidate their losses with income of profitable corporations, a recognized exception to revised consolidated return filing rules. The ability to consolidate losses in this manner was reconfirmed in the Tax Reform Act of 1986. These provisions enabled Native Corporations to "sell" their net operating losses and tax credits to profitable corporations in exchange for cash payments based on a percentage of the tax-savings. In 1988, pursuant to the Technical and Miscellaneous Revenue Act of 1988, the Native Corporation NOL exception was terminated, subject to specified transition rules.

The 1984 and 1986 provisions were enacted because of a Congressional recognition that many Native Corporations had incurred extraordinary operating losses as a result of difficulties arising in implementation of the Alaska Native Claims Settlement Act ("ANCSA"). In 1971, ANCSA directed the establishment of 12 Native Regional Corporations and more than 200 Village Corporations to manage the 44 million acres of land and cash granted to Alaska Natives in settlement of their aboriginal land claims. Section 2 of ANCSA directed that the settlement should be implemented "rapidly . . . in conformity with the real economic and social needs of the Natives . . . ." Despite this mandate, funding and manpower shortages substantially delayed the required conveyances, with land transfers occurring well into the 1980's and some land conveyances not completed even today, more than 20 years after the settlement directed in ANCSA. The Federal Government's delay in completing the aboriginal land conveyances and cash transfers generated hardship for many of the Native Corporations through lost profit opportunities, and caused large NOLs which could not be utilized internally for the foreseeable future. These financial problems were exacerbated by restrictions imposed by ANCSA on the transfer, issuance or sale of any Native Corporations stock through 1991, subsequently extended, which has eliminated the ability of Native Corporations to obtain financing in the capital markets.

To offset these liabilities, Native Corporations were granted this limited exemption from the redefinition of losses which could be consolidated. As a result of the exemption, a significant number of Native Corporations entered into transactions whereby the income of profitable corporations was offset by Native Corporation losses caused by the government's delay in transferring lands. The payments to the Native Corporations, which will be unencumbered only when there is a final administrative or judicial determination, will enable them to become economically viable for the first time since ANCSA was enacted.

The problem we face has arisen in connection with the IRS' examination of these transactions and, specifically, its position that Native Corporations lack standing to litigate the validity of their NOLs. This position is based on a novel theory that treats the taxable income in excess of the allowable NOLs as attributable to or, in effect, "springing back" to the buyer corporation that purchased the NOLs. This, in turn, makes such income taxable to the buyer corporation and eliminates any tax controversy for the Native Corporations, thus depriving them of standing in court. Such an administrative position might not pose a problem if "springback" were applied after a final administrative or judicial determination was made as to the allowable NOLs in the context of a Native Corporation's tax return. However, the IRS has asserted that a mere audit adjustment proposing to reduce the amount of NOLs reported by an Native Corporation on its tax return is sufficient to shift to the buyers any income in excess of the adjusted NOL amounts. The immediate "springback" of income under this approach leaves the buyer as the only party with an asserted tax deficiency that can be contested in court. The Native Corporations remain ultimately liable, however, for any tax finally determined to be due because they entered into indemnity agreements with the buyer corporations which require them to bear the tax liability resulting from any adjustment to their reported NOLs. Thus, if the IRS is successful in challenging the amount of the Native Corporation NOLs in the context of the buyers' tax returns, it is the Native Corporations, and not the buyers, who will bear the ultimate liability for the tax.

The IRS has taken this position notwithstanding the fact that Congress, in 1986, made clear its intention that these sales go forward and not be frustrated by the IRS applying theories of law in contravention to the express statutory provisions. Senator Stevens made explicit, in the Congressional Record on June 23, 1986, that these special tax provisions "were grounded in social policy, the policies of the ANCSA, and not in tax policy considerations" to fulfill the broader social objective of ANCSA. And, as stated in section 60 of the Tax Reform Act of 1986, except as otherwise provided, "no provision of the Internal Revenue Code of 1986 (including sections 269 and 482) or principle of law shall apply to deny the benefit or use of losses incurred or credits earned...". The IRS' "spring back" theory violates this specific legislative admonition and, in the absence of a reversal of its position, standing legislation is needed.

The proposal to create standing is appropriate because the Native Corporations are the true parties in interest, are familiar with the details of the natural resource transactions and issues giving rise to the losses, possess all of the relevant evidence, have a continuing interest in the resolution of the tax issues for future taxable years, and remain liable for the taxes in question by reason of indemnity agreements with the buyers. Thus, they should be allowed to defend the validity of the NOLs in the tax controversy process. Under the current IRS position, the buyers, who do not have the ability to prove the validity of the NOLs in question, may be motivated to concede the resolution of these issues in exchange for more favorable treatment of tax issues of continuing interest to them for which they have their own tax liability.

Moreover, Native Corporations are the only parties with a continuing economic interest in the resolution of the underlying issues. The underlying natural resource valuation issues that gave rise to the NOLs and which must be administratively or judicially adjudicated affect Native Corporation tax items, e.g., depletion deductions and adjusted basis, well into the future. The determination of the proper treatment of the underlying transactions in the NOL cases may establish the valuation and tax basis of the natural resources for all future taxable years of the Native Corporations.

Currently, Native Corporations are in, or are moving to, the final IRS administrative stage--the Appeals Office review process. While at one time it was hoped that many of the cases would be settled at that level, recent meetings with the IRS have proven disappointing. Failure to reach settlement with the IRS will result in the IRS effectuating this unusual "spring back" theory which will transfer all excess income, as determined by the IRS because of its denial of a major portion of a Native Corporation's losses, back to the buyer. The Native Corporation will thus be left with no income, no tax and hence no standing, and the IRS will be in a position to issue a deficiency notice--commonly known as a 90-day letter--to the buyer, which has that time period to file a petition in the Tax Court. Once such a buyer petition is filed, even the subsequent enactment of a provision creating standing for Native Corporations would have no effect since the controversy would already be subject to the court's jurisdiction. That is why this provision is so time-sensitive.

Mr. Chairman and Members of this Subcommittee, we want to emphasize that this provision is procedural in nature and makes no substantive change to the tax law. In fact, it should reduce the IRS' administrative burden by consolidating the handling of multiple cases and accelerating resolution of disputes. The technical aspects of the statutory language and report language have once again been discussed with the JCT staff, and staff at the IRS and DOT, and they have raised no new concerns.

Moreover, the proposed standing provision also provides the following safeguards:

- the buyer corporations must consent to the standing,
- any tax due is determined at the buyer's tax rate,
- any final determination is binding on all parties, and
- interest due on any tax underpayment relating to an ANCSA NOL transaction will accrue at 0.5 percentage points more than the present law underpayment rate.

We want to emphasize again this last point--that the provision pays for itself. To our surprise, last year we learned that this procedural amendment was deemed to have a negative revenue impact. While we do not agree with the concept of associating revenue losses with a simple procedural granting of standing, we fully understand that the budget process requires an offset to the JCT's estimated loss. That is why we worked so hard with the JCT to formulate a mechanism which provides that, in the event of an underpayment resulting from any case in which an election has been made under the provision, the applicable interest rate shall be calculated at the Federal short-term rate plus 3.5 percentage points, instead of the usual 3 points. This incremental increase in the interest rate on deficiency payments will more than offset the revenue loss estimated by the JCT, and the JCT agrees that the provision is revenue-neutral.

In closing, we ask this Subcommittee to endorse a provision which simply guarantees Alaska Native Americans, through their Congressionally created Native Corporations, the fundamental right accorded all Americans -- the ability to contest a tax determination made by the IRS under the full protection of the American judicial system.

WRITTEN TESTIMONY OF JOHN STURGEON, PRESIDENT, KONCOR FOREST PRODUCTS COMPANY, ON H.R. 1997 FOR THE JUNE 24, 1993 PUBLIC HEARING ON MISCELLANEOUS REVENUE ISSUES

Mr. Chairman, I am John Sturgeon, President of Koncor Forest Products Company of Anchorage, Alaska.[1] I respectfully submit the following testimony regarding provisions in H.R. 1997 that would eliminate the use of Foreign Sales Corporations for certain unprocessed timber from private lands.

Introduction

Koncor Forest Products Company is a wholly-owned joint venture of four Alaskan Native Corporations established under the Alaska Native Claims Settlement Act of 1971 (ANCSA) 43 U.S.C. §§ 1601-1624. In ANCSA, the Congress provided a settlement of the aboriginal land claims of the Alaska Native people. Rather than create reservations as in the lower 48 states, the Congress directed that the Native people in each region and each Village in Alaska establish Regional and Village Native Corporations chartered pursuant to State law. These corporations received a prescribed share of the land claim settlement, and were directed by the Congress to operate as for-profit corporations to provide for the economic well-being of their Native shareholders.

Koncor's primary business is the harvesting of timber from lands that it owns throughout southcentral and southeastern Alaska. As there is little domestic market for its timber, Koncor exports substantial amounts of unprocessed timber to foreign markets, where the demand for raw logs is high. The economic livelihood of Koncor and of its Alaskan Native shareholders and employees is dependent upon maintaining free and open access to foreign markets.

There is concern that the Administration and Congress may be prepared to place restrictions on log exports from private lands as a means to help resolve the timber crisis in the Pacific Northwest and elsewhere in the western continental United States. H.R. 1997, the subject of this hearing, would eliminate the use of Foreign Sales Corporations (FSCs) for all unprocessed timber, regardless of its origin. If it is determined that some restrictions on private log exports are needed, or that the use of FSCs for certain unprocessed timber should be eliminated, Koncor strongly urges that such restrictions or changes in existing law not apply to log exports from Native-owned lands in Alaska.

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[1] Koncor Forest Products Company, 3501 Denali Avenue, Suite 202, Anchorage, Alaska 99503.

Restricting Exports of Logs From Native-Owned Lands in Alaska Will Not Help Mitigate the Timber Supply Shortage in the Continental United States

It is Koncor's position that the Federal Government should continue to promote free and open international markets for American forest products and should oppose efforts to restrict exports of unprocessed timber (i.e., logs) from private lands. If the Administration and Congress determine, however, that restrictions on private log exports are needed, or that the use of FSCs should be eliminated for all unprocessed timber, in order to mitigate the timber supply crisis in the Pacific Northwest and elsewhere in the continental U.S., they should continue the longstanding national policy of exempting from any such export restrictions, or changes in existing tax law, timber from lands in Alaska owned by Alaska Native Corporations. Changing existing law to restrict or discourage log exports from Native-owned lands in Alaska would provide no assistance to domestic mills and mill workers in the continental U.S. and would only serve to eliminate timber-related jobs in Alaska and to preclude economic opportunities that have only recently been provided to the Alaska Native people.

Export Policy

It has long been our national policy to promote exports of American made goods, in general, and American forest products (logs and processed wood products), in particular. For example, the Federal tax code promotes exports of American products by offering favorable effective tax rates to FSCs. Export restrictions serve to widen the nation's trade imbalance and to undermine efforts to eliminate foreign trade barriers, and are inconsistent with the United States' opposition to foreign export controls on unprocessed materials. Generally, Congress limits or discourages exports only on a temporary basis where necessary to relieve a shortage of essential products or to conserve a scarce resource.

For the past 20 years, Congress has responded to a perceived shortage in public timber supplies in the western and northwestern regions of the country by banning exports of logs from Federal lands in the western continental United States. From 1973 to 1990 Congress banned log exports from Federal lands in annual Interior appropriations bills. With the passage of the Forest Resources Conservation and Shortage Relief Act of 1990 ("1990 Act"), Congress made the Federal log export ban permanent, and extended the ban to state lands in the West and Pacific Northwest, as well.

Export of Alaska Timber

Proponents of export restrictions and elimination of the use of FSCs for raw logs harvested from private lands argue that such measures are now needed in order to save domestic sawmills and thousands of mill jobs in the Pacific Northwest and the Rocky Mountain region. Congress has long recognized, however, that banning, restricting, or discouraging log exports from any lands in Alaska (or in the eastern United States) will not mitigate the shortage of timber supply in the Pacific Northwest or elsewhere in the lower 48 states. For this reason, limitations on log exports from Federal and state lands have always been focused upon those particular geographic regions in short supply and have not been applied to far-off lands in Alaska.

Timber harvested in Alaska cannot be used to relieve the timber supply shortage in the continental United States. The vast distances from Alaska's forests to mills in the Pacific Northwest and elsewhere in the lower 48 states make transportation of raw logs infeasible. Restricting or discouraging the export of logs from private lands in Alaska will not solve the timber supply shortage in those areas; it will result only in the termination of timber harvesting in Alaska.

Native Corporation Timber

In addition, Congress has recognized the unique status of Native Americans and has enacted special exemptions from log export restrictions for lands held in trust for Indians and for lands owned by Alaska Native Corporations. For example, in the 1990 Act, Indian tribal lands and Alaska Native Corporation lands are excluded from the definition of "private lands." As such, Indian tribes and Alaska Native Corporations are exempted from the Act's restrictions on direct substitution (i.e., prohibition against purchasing Federal logs to be used in substitution for logs exported from private lands).

Eliminating the use of FSCs for unprocessed timber harvested from lands owned by Alaska Native Corporations would also be contrary to the purposes of ANCSA. In ANCSA, the Congress sought to provide Alaska Natives with the means by which they could achieve economic self-sufficiency and independence. The 44 million acres of land conveyed to the Alaska Native Corporations provide the primary means by which this economic self-sufficiency may be attained. Since most timber on lands owned by Alaska Native Corporations has value only in the export market, eliminating valuable tax benefits associated with the export of this timber would eliminate any economic benefit to the Alaska Native shareholders of these Native Corporations as a result of the Native claims land settlement. Restrictions on log exports from Native-owned lands would directly contravene the purposes expressed in ANCSA.

Finally, applying the FSC provisions contained in H.R. 1997 to lands owned by Alaska Native Corporations would be contrary to the principles underlying the Federal Government's trust responsibility to Native Americans. Pursuant to its trust obligations, the Federal Government has historically promoted Native American economic development in a variety of ways, including, but not limited to, direct Federal services, Federal grant and loan programs, preferential employment laws, and tax incentives.

Thus, if it is determined that some additional log export restrictions, such as the elimination of FSCs for unprocessed timber, are needed to help relieve the timber supply shortage in the Pacific Northwest, sound policy dictates that such restrictions be applied carefully and narrowly. The Federal policies expressed in ANCSA can only be achieved by excluding Alaska Native Corporation lands from any new log export restrictions or disincentives. To ensure this result, changes in existing law relating to private log exports should be limited to those geographic regions (e.g., Pacific Northwest) where there is a shortage of logs.

Conclusion

Since restricting private log exports in Alaska will not remedy the timber shortage in the Pacific Northwest or elsewhere in the continental U.S., Congress and the Administration should continue the longstanding national policy of excluding Alaska Native lands from any such restrictions. Such restrictions or disincentives would only have negative trade and economic impacts and would directly contravene Federal policies intended to advance the self-sufficiency of the Alaska Native people. If access to overseas markets is closed or restricted, Alaska Native Corporations will suffer significant losses in revenue and the value of their timberlands will be drastically reduced.

Art Institute of Southern California *2222 Laguna Canyon Road Laguna Beach, CA 92651 714·497·3309 Fax 714·497·4399*

September 30, 1993

The Honorable Dan Rostenkowski
Chairman, Ways and Means Committee
U.S. House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

On Wednesday, September 8, Fred Lazarus, IV testified on behalf of the Association of Independent Colleges of Art and Design before the House Ways and Means Subcommittee on select revenue measures.

The testimony given by Lazarus was in support of our proposal to urge Congress to amend Internal Revenue Code, Section 170(e)(4), to allow computers and other like equipment to be donated to colleges and universities for use to advance design and design theory within the definition of allowable research, experimentation, and research training as is now the case for scientific research.

The current language in the tax code precludes equipment manufacturers from contributing such equipment to colleges where the intent of the donee is to use the equipment to advance design theory or develop new concepts and uses of design. The change we are requesting would assist our nation tremendously by increasing the rate of progress possible in design research at the college and university level.

I hope we can count on your support of this request.

Sincerely yours,

John W. Lottes, President

copy: Representative Charles B. Rangel

HARSCH
INVESTMENT CORP.

STATEMENT OF HAROLD AND ARLENE SCHNITZER AND HARSCH INVESTMENT CORPORATION

Before the House Ways and Means Committee on Select Revenue Measures
July 1993

Changes to Encourage Donations to Private Foundations Including the Extension of Section 514(c)(9) To Include Certain Foundations

Mr. Chairman and members of the Committee, we appreciate this opportunity to testify on proposals that would be important not only for us but also for other private foundations as well as the charities foundations help finance. The provisions our statement supports also are consistent with tax provisions in the pending budget bill designed to encourage economic growth by making it easier for tax exempt pensions to invest in real estate.

The Harold and Arlene Schnitzer Family Foundation was established in 1991 by Harold and Arlene Schnitzer to help support public charities. The Foundation's distributions are made for religious, educational, and social services purposes and for the arts. Approximately 60% of annual distributions will be for religious and educational purposes and the arts. The remainder will be for medical purposes, including research, scholarships, and medical libraries, and for social services -- with an emphasis on programs for women, youth, the elderly, the disadvantaged, and the disabled.

The Foundation was established by a philanthropic family who would like to donate additional assets from their investments. These investments consist almost exclusively of closely-held stock and debt-financed real property which in many instances have been held for extended periods. However, current tax laws discourage donations of such assets. We are pleased to submit for the record our statement in support of proposals to change some of those tax laws.

Legislative Proposal to Extend the Exception for Debt-financed Investments in Real Property to Certain Private Foundations

In particular, we strongly support the concept of including private foundations in the category of organizations that qualify for the special exception from the debt-financed income rules of section 514(c)(9). The proposal before the Committee would treat, in a very limited way, certain private foundations the same as pension funds and educational organizations under the unrelated business income rules for debt-financed property.

The problem generally is that if private foundations receive or hold debt-financed real estate, then rental income or sale proceeds would be characterized as taxable income. Consequently, the tax liability reduces the funds available for foundation grants. The debt-financed rules do not apply to all tax exempt organizations. An exception was created in 1980 for pension funds and broadened in 1984 to cover educational organizations. This exception enables these organizations to exclude income from debt-financed real estate from UBIT.

We would support a similar exception for private foundations, but broader than that before the Committee. It is important that any exception for private foundations be available to all worthy foundations. We believe that private foundations should be permitted to invest in real estate, a capital-intensive investment normally encompassing indebtedness, without restrictions that limit its effectiveness.

Revising the current Section 514(c)(9) exception for pensions and educational organizations to also include certain private foundations is consistent with the Clinton Administration proposals in the pending deficit reduction bill that were drafted to encourage pension investments in real estate. Those provisions have been approved by the House and the Senate because, according to the committee reports, the committees believe "that modifications to the debt-financed income rules are desirable to permit qualified organizations to make debt-financed investments in real property on commercially reasonable terms in circumstances where the [committees believe] there is no potential for abuse." That rationale supports extending the Section 514 exception to certain private foundations. We believe that the extension to private foundations would add investment support to the real estate industry, at the same time enabling private foundations to make investments on a prudent basis.

Additional Legislative Suggestions

In addition to supporting revisions to the debt-financed rules which would permit private foundations to exclude income from debt-financed real property from UBIT, we also support other changes which would permit tax exempt organizations to increase the funds available for foundation grants.

The Internal Revenue Code currently includes many provisions that discourage charitable contributions of certain types of property. Two types of disadvantaged property, for example, are (1) real estate encumbered by a mortgage and (2) stock in a corporation with low-basis and high-value assets. Charitable contributions of these two types of assets receive less favorable treatment than contributions of other assets. Unfortunately, such assets are more common than unencumbered real estate or closely-held corporations with high-basis assets. The situation is even less favorable if the donee charity is a private foundation. In addition, private foundations generally are forced to dispose of closely-held stock because of excess business holdings restrictions.

Additional funds would be generated for charities if holders of encumbered real estate and closely-held stock could be encouraged to donate assets to private foundations for distribution to other charities. Donations of these assets could be "unlocked" by changing some of the current tax laws that govern donations to private foundations. We would appreciate this Committee's consideration of the following additional proposals: (1) allow certain but limited tax-free corporate liquidations after stock has been donated to a charitable organization; (2) amend the debt-financed UBIT rules to make it more attractive for charitable organizations to receive, hold or sell the property; (3) ease the bargain-sale treatment of debt-financed real estate; and (4) eliminate the charitable reduction rules with respect to contributions of closely-held stock and appreciated real property to private foundations. These four changes would unlock charitable donations of encumbered real estate and closely-held stock and in turn increase the financial support available from foundations for charitable endeavors.

1. **Liquidation of Donations of Closely-Held Stock**. Generally, when property is distributed as part of a corporate liquidation of a subsidiary, the majority shareholder does not recognize gain or loss. However, if the property is distributed in liquidation to an exempt organization, it may have to recognize the gain at the corporate level. We propose eliminating the tax under certain circumstances on this gain to remove a disincentive for individuals to donate, and charities to accept, controlling interests in closely-held corporations.

2. **Additional Changes to Debt-Financed Rules**. The rules governing taxation of unrelated business taxable income received by charities from debt-financed property should be amended so they do not apply to certain types of property. We would propose a ten-year exclusion of income from debt-financed real property acquired as part of a corporate liquidation in which a controlling stock interest was acquired by the charity by gift or bequest. This clarifying change would treat debt-financed property received in a liquidating distribution the same as debt-financed real property received directly by gift or bequest -- the properties would not produce taxable income from investment or upon sale for a period of 10 years. This proposal would make it more attractive for charitable organizations to receive, hold, and sell debt-financed property.

> **Illustration:** To illustrate the effect of the above proposals relating to liquidations and debt-financed rules, consider an individual who leaves 100% of the stock of a closely-held corporation to a private foundation at death. There is little or no market to sell the stock; but there is a market for the corporation's real estate assets. Alternatively, the charity could hold the assets directly and receive the rental income.
>
> Under current law, if the corporation is liquidated, there will be a tax at the subsidiary level unless the property is used in an unrelated trade or business. Additionally, if the charity sells the debt-financed property, the charity will recognize gain in proportion to the debt on the property or would be taxed on a portion of the rental income as debt-financed income.
>
> Under the above two proposals, there would be no gain to the subsidiary on liquidation and no gain when the charity sells the property. The same result would occur under current law if the individual had held outright an apartment building and donated it to a foundation.

3. **Charitable Contributions of Real Property Encumbered by Debt**. A taxpayer who has owned real property at least 10 years and transfers it to a charitable organization would not recognize taxable income by reason of the "bargain sale" rule in most cases under the proposal. As under current law, gain would be taxed to the extent the adjusted basis of the property is less than the debt assumed by the charity. However, we propose that the donor not recognize taxable gain due to the "bargain sale" treatment, in the absence of debt in excess of adjusted basis, by virtue of having made a charitable contribution.

4. **Charitable Contributions of Appreciated Property to Foundations**. We also propose eliminating a provision of current law that reduces the charitable contribution deduction in some cases because the donee organization is a private foundation. Our proposal would change the rules that require a reduction of the charitable deduction for contributions to a private foundation of appreciated property if the gift is certain closely-held stock or certain real property. Under our proposal, the taxpayer generally would receive a charitable deduction equal to the fair market value of the property. This proposal would treat contributions to all Section 501(c)(3) organizations more equitably and consistently.

Conclusion

These proposals would help modernize the tax laws and stimulate the additional contributions that could be made to charitable organizations. Public charities and private foundations remove a significant financial burden from government and transfer it to the private sector. Encouraging additional contributions will further leverage the tax costs to enable these organizations to meet the many social needs and reduce reliance on government programs.

We further believe that private foundations are providing a very effective delivery of funds to a very diverse, wide ranging group of social support organizations on a timely basis. Foundations can, and do, act as incubators for new and developing charitable organizations. The variety, as represented by the tens of thousands of private foundations, permits diversity of views, processes and charters that encourage continued innovations in the delivery and effective use of resources in the charitable sector.

Mr. Chairman and members of the Committee, if there are any questions or if you need any additional information, please feel free to contact Harold J. Schnitzer (503-242-2900) or Theodore Malaska (503-242-2900) in Portland, Oregon.

WRITTEN STATEMENT OF BOYD M. COOK
AREA MANAGER OF DAIRYMEN, INC.
SUBMITTED TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

IN CONNECTION WITH ITS HEARINGS ON MISCELLANEOUS REVENUE ISSUES HELD ON JUNE 17, 1993 AND SUBSEQUENT DAYS

The Middle Atlantic Division of Dairymen, Inc. appreciates the opportunity to submit these comments for inclusion in the record of the hearings held by the Subcommittee on Select Revenue Measures on miscellaneious revenue issues. Dairymen applauds the Subcommittee for it's efforts to improve the tax system by providing a forum in which these issues may be explored and addressed.

Dairymen is a milk marketing cooperative that markets the milk of 3,500 dairy farmers in the Southeastern States.

Dairymen supports the proposal to repeal section 58(a) of the Internal Revenue Code. In our opinion, section 58(a) is unnecessary and serves only as a potential trap to the unwary farmer. As currently written, this section prohibits the deduction of "tax shelter farm activity" losses from alternative minimum taxable income, whether or not the taxpayer is an active or "real" farmer. If repeal is not possible, Dairymen urges that the provision be reformed so that it allows farm activity losses to be deducted by active farmers.

Assistant Secretary (Tax Policy) Samuels in his testimony before this Subcommittee on June 22, noted that the Treasury Department does not oppose the repeal of section 58(a).

In the Tax Reform Act of 1986, Congress adopted several limitations on tax shelter farming activity. These limitations were designed to prevent nonfarmers, who were otherwise able to shelter nonfarm income with farm losses, from artificially impacting the competitive balance of the farming industry.

The most important of these limitations are those contained in the passive activity rules of section 469, which prohibit deduction of farming losses by nonfarmers, effectively addresses this concern. The only thing section 58(a) adds to the passive activity rules is to also prohibit current deduction for **active** farmers, a result that is counter to the stated purpose of Congress in adopting limitations in this area.

Section 58(a) is also a highly technical and potentially confusing provision, creating a trap for the unwary and an invitation to noncompliance. The instructions to Form 6251 (Alternative Minimum Tax Computation for Individual), as lengthy as they are, do not explain what a tax shelter farm activity is. The only guidance they offer is a reference to the Internal Revenue Code and the complex trail of references and cross-references therein that must be navigated to discern the necessary definition. There appears to be virtually no discussion of the issues raised by the provision in tax publications. More importantly, there have been no court cases, IRS rulings or Treasury guidance (aside from instructions to the Alternative Minimum Tax form for individuals) issued since the provision was enacted.

I appreciate the opportunity to submit these comments on this important issue, and would be pleased to answer any questions members of the Committee mayhave about this testimony.

TESTIMONY OF JAMES D. PENDERGRASS
GENERAL MANAGER, WESTERN FARMERS ELECTRIC COOPERATIVE

On behalf of Western Farmers Electric Cooperative, Inc. (WFEC), James D. Pendergrass, General Manager of WFEC submits the following statement:

WFEC is a generation and transmission (G&T) cooperative operating in the State of Oklahoma. Its function is to provide electric energy on a not-for-profit basis to its members, which are distribution cooperatives. However, to the extent WFEC has excess generating capacity available, it does sell to nonmembers on a for-profit basis.

In the late 1970's, in an effort to maintain self sufficiency in power production, WFEC began construction of a 400-megawatt generation station at Hugo, Oklahoma. This facility was placed in service for tax purposes in April of 1982. Until 1982, WFEC operated as a tax exempt entity and filed Form 990 with the Internal Revenue Service (IRS).

However, anticipating an increase in nonmember sales due to available excess capacity at Hugo, WFEC began to operate as a taxable cooperative; accordingly, a Form 1120 was filed beginning with its 1982 calendar year. WFEC has consistently filed Form 1120 each year since 1982. Also in 1982, WFEC transacted a "safe harbor" lease which was not a true sale/leaseback, but rather a transfer of tax benefits pursuant to Section 168(f)(8) of the Internal Revenue Code of 1954, as originally enacted by Section 201(a) of the Economic Recovery Tax Act of 1981. The lease involved the Hugo Power Plant and certain transmission facilities.

Since 1982, WFEC has filed its tax returns applying the principles of Section 277 (deductions of certain membership organizations), thereby segregating income and deductions relating to its not-for-profit member business from those relating to its profit-oriented nonmember business. Since WFEC's operations do not allow for a strict separate accounting for costs attributable to its nonmember business, reasonable allocation methods were used where the direct identification of costs with a particular type of business was not feasible.

As a consequence of applying Section 277 principles, WFEC segregated the income and deductions attributable to its safe harbor lease of Hugo. In this context, it recorded safe harbor interest income as a nonmember source as if it had actually sold the Hugo facility. Against this income, WFEC matched the "rental" expense created as a consequence of the "safe harbor" tax benefit transfer. The entries, which do not represent the actual receipt of income or payment of an expense, were for tax purposes only and, accordingly, no entry appears on WFEC's financial books for this purpose. WFEC's approach was consistent with industry accounting practice and clearly reflected its income for tax purposes.

On a subsequent audit, the IRS proposed to treat the income as 100% nonmember and allocate the "rent" against the separate member and nonmember income accounts. This treatment produces a large loss from dealing with members, a large gain from nonmember business, and a huge tax liability. The IRS also proposes to apply Section 277 to prevent an offset of the resulting "member" loss against "nonmember" income.

WFEC has objected to this proposed adjustment. WFEC continues to hold its position that the original matching of rent deductions and interest income as both nonmember sources is supported by case law and the IRS's own rulings; that the matching is supported by accounting theory and industry accounting practice; and, that the IRS's proposed position would result in a massive distortion of income.

WFEC does not believe that Congress ever intended for the safe harbor lease provisions to ensnarl any particular industry. However, because of Code Section 277, the IRS has taken one transaction which can be traced to one lease document, and has stifled a large segment of the electric cooperative industry. The IRS's position would create problems for at least 14 G&T's serving customers in 21 states. In WFEC's case, the rate impact to its 460,000 ultimate consumers would be disastrous. Likewise, this situation would be just as disastrous for the other 13 G&T's and the millions of consumers served throughout the United States.

WFEC has been under audit for its 1982 and subsequent tax returns since 1985, and has made numerous attempts to resolve this issue. WFEC has made several offers to settle, but the IRS has not agreed to any type of settlement so far, insisting that the issue be settled on its terms. WFEC has also attempted to have clarifying legislation passed to resolve this issue. However, each time the legislation has been stripped from the final bill. WFEC would very much like to settle this issue as it has begun to affect other areas of the cooperative and hinders management in decision making.

In conclusion, the proposal put forward by Representative Bill Brewster, Democrat from Oklahoma, would resolve this issue for WFEC and the other G&T's affected by this unfair tax treatment. Therefore, your support of Representative Brewster's proposal would be appreciated.

STATEMENT ON BEHALF OF THE AMERICAN VINTNERS ASSOCIATION

IN SUPPORT OF

THE PROPOSAL TO PHASE OUT THE SPECIAL OCCUPATIONAL TAX

Hearings on Miscellaneous Revenue Issues
Subcommittee on Select Revenue Measures
House Ways and Means Committee
June 22, 1993

Chairman Rangel and Members of the Subcommittee:

The American Vintners Association ("AVA") is pleased to have the opportunity to submit this statement strongly supporting the proposal to phase out the Special Occupational Tax ("SOT") provisions of Part II of Subchapter A of Chapter 51 of the Internal Revenue Code.

The AVA is the national trade association of American wineries representing approximately 350 wineries in 36 states. The overwhelming majority of the AVA members are small family farm wineries whose sales are focused in their local region and to local tourists. These small businesses already pay an inordinate amount of excise taxes, state and local operating fees and sales taxes and when profitable, federal and state income taxes. In addition to all of these burdens, American wineries are also required to pay a minimum of $500 in SOT for the privilege of operating a winery. However, many of our members pay significantly more than $500. Those with gross receipts over $500,000 must pay a $1,000 annual SOT. Our members who have more than one facility are required to pay an SOT for each facility. Those members who operate independent tasting rooms off of the winery premises must pay an additional $250 SOT per retail location per year. Even if the retail location is open only for the Christmas season, they must pay. If our members or their local organizations decide to hold a wine fair or wine tasting event where wine will be sold, another SOT must be paid. Finally, if a winery needs to use the services of a group wine warehouse to store and ship its wine to its customers, it must pay a wholesaler SOT in addition to all of the above fees.

The SOT was initially invoked by Congress to help pay for costs arising from fighting the Civil War. In 1987, the SOT on wineries more than doubled, dealing a significant blow to the growth of the family-owned wineries in the United States. It's time for its repeal.

The wine industry presently pays billions of dollars annually in excise taxes. It is one of the few agricultural industries in the United States that is required to pay excise taxes. The SOT, which must be paid whether or not the winery produces wine in any given year, is an extremely regressive anti-small business tax. It is also a tax that puts American wineries at a disadvantage with their foreign competitors. Foreign producers who export wine to the United States and compete directly with American wineries are not required to pay the SOT. It is uniquely a tax on American producers.

In contrast to all of the burdens that the SOT places on the wine industry, there is no discernible benefit from the tax. Although the tax is administered by the Bureau of Alcohol, Tobacco & Firearms ("BATF") the revenue collected is channeled back into the general Treasury. It does not pay for BATF activities. In fact, notwithstanding all of the revenues American wineries contribute to the U.S. Treasury annually, this Committee recently took action to require wineries to pay another fee -- a $50 User Fee for each label application the winery submits to BATF for approval. Our members are left to wonder what is the purpose of the SOT. The answer is clear -- it has no purpose and only serves to add costs to an already overburdened industry.

The General Accounting Office ("GAO") has also asked the question, what is the purpose of the SOT? In studying the SOT, the GAO has determined that Congress should repeal the SOT, concluding that it is a very costly program to administer considering the small amount of revenue it generates.

The American Vintners Association concurs with the GAO assessment and urges this Committee to finally repeal this unfair burden on the wine industry.

Statement of

Hon. Paul E. Kanjorski

Before the Ways and Means Committee
Subcommittee on Select Revenue Measures

June 22, 1993

Mr. Chairman, I appreciate the opportunity to offer my testimony to the Subcommittee on Select Revenue Measures as it considers the Special Occupational Tax.

The gist of my testimony is this: If the Subcommittee decides to repeal the Special Occupational Tax, it should also enact a long-overdue statute of limitations on collection of the tax; indeed, the statute of limitations should be enacted even without changes in the Special Occupational Tax.

I first learned about the Special Occupational Tax when a small Elks Club in my district told me they had just received a bill for $9,776.98 on a tax they had never heard of, and which neither the IRS nor the Bureau of Alcohol, Tobacco and Firearms had ever attempted to collect. Much to the club's surprise, they were being dunned for taxes owed as far back as fifty years ago. I subsequently introduced legislation to remedy this injustice.

On October 26, 1989 the Select Revenue Measures Subcommittee held a hearing on a number of revenue proposals, including my bill, H.R. 2285, to impose a statute of limitations on past nonpayment of special occupational excise taxes by retail dealers of alcoholic beverages.

This legislation, which was cosponsored by 68 members of the House, is necessary because a ''catch-22'' in existing law results in an unexplained absence of any statute of limitations whatsoever. Most retail dealers were never advised of the existence of the tax. Even non-profit groups have received sudden dunning notices for years back taxes (plus interest and penalties) for a tax they never knew they owed.

At the 1989 hearing, Assistant Treasury Secretary Kenneth W. Gideon stated: ''There is no evidence that dealers were attempting to avoid the tax... [and] lack of knowledge was the primary cause for noncompliance for years before 1987.'' He also stated that, due to the small revenue impact of this proposal (less than $2 million according to the Joint Tax Committee), the Administration he served did not oppose enactment of this legislation.

A provision identical to H.R. 2285 was approved by the Senate Finance Committee during its consideration of a previous reconciliation bill.

The bill I introduced this year, H.R. 609, is identical to H.R. 2285. It strikes a reasonable balance between the obligation to pay taxes owed and the right to be free of harassment based on a tax few ever knew existed. We need to keep in mind that the government made no effort to collect this tax, or even notify people about it.

H.R. 609 requires the payment of taxes, interest and penalties back to 1985, but it forgives taxes for prior years. There is ample precedent in other sections of the tax code for such a statute of limitation.

The Subcommittee should consider abolishing the Special Occupational Tax, which raises little revenue but nevertheless impose a financial and administrative burden on more than a half million small businesses. If the Subcommittee does choose to repeal the tax, it should also put in place a reasonable statute of limitations to protect small businesses and non-profit organizations from the kind of harassment such repeal is designed to prevent.

Furthermore, even if the Subcommittee chooses to keep the Special Occupational Tax in place, it is important that the Subcommittee enact a statute of limitations. The government must aggressively pursue the collection of unpaid taxes, of course, but there is in American law an accepted limitations on how far back in time the government pursue collection of a tax. Adding a statute of limitations simply brings the special occupational tax in line with the rest of the tax law.

I appreciate the opportunity to bring these concerns to the Subcommittee, and I encourage members of the Subcommittee to contact me if they have any questions.

Thank you.

THE SOUTHLAND CORPORATION
2711 N. Haskell Avenue
Dallas, Texas 75204-2906
(214) 841-6599

June 22, 1993

Statement of
The Southland Corporation
Before the
Select Revenue Measures Subcommittee of the
Committee on Ways and Means
United States House of Representatives

Mr. Chairman and Members of the Committee, The Southland Corporation and its nearly six thousand 7-Eleven stores nationwide, half of which are operated by local franchisees, is grateful for the opportunity to submit this statement in support of the proposal to phase out the "special occupational taxes" (the "SOT's") on liquor dealers and merchants in part II of subchapter A of chapter 51 of the Internal Revenue Code.

We are also especially grateful to the Committee for including SOT repeal in the group of miscellaneous tax provisions being considered today. As Representative Matsui stated last year when SOT repeal came before the House, the SOT is an "antiquated and inequitable tax" whose relative high cost of administration is not justified when compared to the modest revenue raised and the extraordinary burden which it places on producers, distributors and dealers of licensed beverages.

Unfortunately as a result of Congress' failure to take final action with respect to SOT repeal last year solely because of objections to the revenue offset then being proposed, the inequity has continued, making it imperative that action be taken in this Session.

Background

The history relative to the SOT's original enactment, and Congress' decision to increase it by vast proportions six years ago, are worth reviewing briefly because they highlight the unfairness with which this tax was expanded, and the harshness with which it is being assessed against medium and small businesses already wary of rising federal taxes.

As a number of Representatives pointed out during the debate last year on SOT repeal, while the SOT is not a new tax, it is one which essentially lay dormant for almost one hundred and thirty years before being revived by Congress with virtually no warning to those affected, and whose original purpose was fulfilled long ago.

Although much attention has been paid to the SOT's over the past six years, the SOT actually was enacted in the 1860's as a means of paying for federal expenditures relating to the Civil War. Regardless of how successfully the SOT fulfilled its original purpose, it had been forgotten and thoroughly ignored both by the American public and without question by the federal government agencies which are charged with its enforcement until Congress rediscovered it during consideration of budget reconciliation legislation in 1987.

As enacted in Civil War days, the SOT was a "nominal" levy on purveyors of distilled spirits in the amount of $25 per year. Although in this century the SOT largely was ignored and rarely was enforced, Congress increased it slightly over the years and by 1987, the tax on retail dealers had risen to $54 per year. That year, however, in its search for additional federal revenues Congress increased the SOT by vast proportions, without affording the affected businesses the benefit of a public hearing or any other clear warning that this generally forgotten levy was being revived and drastically increased.

As modified in 1987, the SOT is now a significant burden both financially and administratively. The tax on retail dealers, for example, was increased to $250 per year, a fivefold increase from its previous level. The tax on wholesalers was increased to $500, and on producers to $1,000 per year ($500 in the case of producers having gross receipts of less than $500,000 per year).

The SOT Is Unfair

Although the SOT was enacted for a specific purpose, namely to raise revenues to defray the cost of the Civil War, it has no apparent special purpose today. The businesses which are required to pay it do not receive any special license for it, and in fact, it has been traditional under this Nation's political system for state and local governments, rather than the federal government, to license business generally, and liquor dealers in particular. Further, unlike many other existing excise taxes, the relatively small revenues raised by the SOT are not devoted to any specific purpose, such as to fund environmental cleanup, rebuild the Nation's highways, or to maintain the civil aviation system.

Quite the contrary, the SOT is little more than a costly and burdensome method of raising a small amount of additional federal revenues, and unfortunately, the SOT does so in a manner which is highly regressive and unfair to small and medium businesses.

The retail level tax of $250 would apply equally to a large well established liquor store or national supermarket chain store with a high volume of liquor sales as it would to a convenience store run by a local neighborhood franchisee which sells a small amount of wine during the year. The difference, however, is that the large establishment would have a far easier time absorbing the cost of the tax, or passing it along to consumers, while the tax presents an extraordinary additional burden to the franchisee. As Representative Matsui pointed out in the House debate on SOT repeal last year, the producer level tax is equally regressive in that "a chain of four neighborhood food stores pays the same annual special occupational tax as the Nation's largest single-site brewery or distillery plant."

In effect, the SOT imposes a serious financial and administrative burden on hardworking small and medium businesses, and provides no clear benefit in return.

The SOT Is Inefficient

Reports by the General Accounting Office to the effect that the Bureau of Alcohol Tobacco and Firearms is having a particularly difficult time identifying all of the alcohol retailers who technically are subject to the SOT, reveal that the law at best is being administered in a very selective and very unfair manner. In the case of other levies such as the excise tax on diesel and aviation fuels, the Internal Revenue Service expends a considerable amount of effort to notify potential taxpayers and keep them up to date as to their potential obligations, and while these compliance programs are not perfect, they do help to minimize the selectivity of application. In the case of the SOT, the extraordinary burden of simply identifying which dealers should be subject to the tax is so great by comparison that even with considerable similar outreach efforts the tax is likely to remain a tax which will always be implemented in an extremely selective manner.

In fact, as the Congress heard last year during the debate on SOT repeal, numerous small and medium businesses, and even some local fraternal organizations, were dismayed to find that Congress' rediscovery of the SOT in 1987 motivated a series of demands for back SOT taxes by the BATF, some leading to costly and unpleasant confrontations between the businesses and their government over a relatively amount of revenue. We respectfully submit that the evidence is overwhelming that the SOT accomplishes little more than to misallocate badly needed federal agency fiscal resources while raising a negligible amount of federal revenue.

It is no wonder therefore that the General Accounting Office repeatedly has advocated the repeal of the SOT's. Some estimates suggest that the cost of administering the tax may reach as much as one fourth of the amount collected, making SOT one of the least efficient levies imposed by the federal government.

SOT Repeal Would Help Restore Faith In Government

There has been much discussion recently both in and out of government about the need for decision makers in Washington to restore the American people's faith in their public institutions. We submit that the revival of SOT in 1987 is the type of action that reduces faith in government. In effect, the recent history of the SOT reveals a situation in which without hearings or any form of public warning Congress imposed a relatively burdensome and regressive tax on a wide ranging group of producers, wholesalers, and retail dealers in alcoholic beverages. Worse yet, the agencies charged with enforcing this tax decided in some cases not only to collect the new higher levy, but to attempt to collect on a retroactive basis for many years a tax which the government itself ignored at the time.

The 1987 proposal to revive and increase the SOT's should have been the subject of precisely the type of hearings and public comment which the Committee has afforded affected companies in this Session. By adopting the proposal now before the Committee to phase out the SOT's, Congress would go a long way to restore public faith in government by supporting the principle that taxes should not imposed without warning, and that taxes which have no clear purpose, which are regressive, and which cannot be enforced in a fair manner should not be enacted at all.

Respectfully submitted,

Ronald L. Platt

Statement of Senator Alfonse M. D'Amato

Before the Ways and Means Committee

June 22, 1993

Mr. Chairman, I am pleased to make this statement in support of Mr. Rangel's proposal to preserve existing federal tax incentives for New York City's Time Square--42nd Street urban renovation project by removing the deadline for placing in service properties that are part of the project.

In 1986, I was one of the principal sponsors of an amendment to ensure that these incentives were provided for the project. With the able assistance of other members of the New York delegation--including Senator Moynihan and Mr. Rangel--and many others, tax incentives were preserved to assure completion of this massive long-term urban renovation project.

The project's goal is to redevelop the world famous landmark, Times Square, and the surrounding area. In the short term, it will include renovations of historic theaters and interim low-rise development. In the longer term, it will also include the construction of new office towers, hotels, and a trade center. The project is supported by New York City and the New York State Urban Development Corporation, but it is almost entirely reliant on private development and financing.

The project's potential benefits to New York City are immense. There is no question that the Times Square area suffers from blight, physical decay and a high crime rate. As a symbol of the City, its decline becomes an important reflection of New York to the rest of the world. The project is the best hope to reclaim the Square's former glory and renew its contribution to the City.

In 1986, Congress recognized the value of this urban renovation project by grandfathering pre-1986 cost recovery tax rules for property which was an integral part of the project. Also, in recognition of the magnitude of the project and the potential difficulties which it might encounter, Congress provided an extended place-in-service deadline of January 1, 1998 for project property to qualify for the transition relief (in contrast to the generally applicable date of January 1, 1991 for property in most other urban renovation projects), but did not, as it did for at least 69 other projects, remove the project completely from the deadline as it should have for such a long term effort.

The plan will require private developers to invest over $2.5 billion in the project. They have already incurred or committed over $250 million without having received any return and with no prospect for near-term returns on their huge investment. Much of this amount was committed after 1986 in reliance on the incentives provided that year. The tax incentives preserved by the 1986 act are necessary in this tight real estate market for them to attract long-term tenants to the project.

Unforseen delays will prevent the developers from meeting the 1998 deadline for many portions of the project. These delays have been caused by the extraordinary duration of litigation brought by local property owners and others and by radical changes in the demand for commercial office space. In addition, the City and State are planning to amend the project plan to defer construction of the office towers and add interim low-rise development, looking again to the private developers to finance development costs approaching another $100 million.

By removing the January 1, 1998 placed in service deadline, this amendment will preserve tax benefits not only for the office towers, but also for other parts of the project including all of the theaters, the hotel and the trade mart. However, the amendment will not alter the usual tax law rule that cost recovery deductions may begin for tax purposes only when property is actually placed in service.

Prompt action is needed on this amendment to provide an economic basis for the developers to remain in the Project. That will require them to make enormous financial commitments--including substantial unanticipated financial commitments for the new interim low-rise development and financial contributions to renovate the theaters to be owned and operated by others-- long before any return on their investments can be realized. Prompt action is also necessary so that the developers can utilize the availability of the tax incentives to encourage lessees to make long-term commitments to lease space in the buildings, a prerequisite of obtaining construction financing.

This project is, and has been, a part of our effort to revitalize our cities. We have encouraged developers to make major investments in urban renovation projects as part of a comprehensive attack on our urban problems. In my judgement, we will need to continue to encourage large renovation projects--as well as small business activities--in blighted inner city areas if we truly wish to revitalize these areas. If Congress is to encourage such investment, developers must know that we will assist them when unseen delays threaten the loss of anticipated benefits we have previously provided.

Mr. Chairman, it is my understanding that under the current rules for the scoring of revenue impact, enactment of this provision this year will not result in any revenue loss during the five-year period used for federal budget estimates.

Mr. Chairman, thank you.

STATEMENT OF
VINCENT TESE
NEW YORK STATE
DIRECTOR OF ECONOMIC DEVELOPMENT
CONCERNING ITEM #14, MISCELLANEOUS ISSUES
HOUSE COMMITTEE ON WAYS AND MEANS
HEARING: JULY 1, 1993

Thank you Mr. Chairman, for this opportunity to present the State of New York's position regarding item #14 of miscellaneous issues on your hearing calendar which would extend the placed in service date as specified in 204(a)(1)(E)of the Tax Reform Act of 1986 for projects of which our interest is the Times Square - 42nd Street Development Project.

The 42nd Street Development Project, located on 42nd Street, between Seventh and Eighth Avenues, in Midtown Manhattan, is a keystone urban renewal project sponsored by the City of New York and the New York State Urban Development Corporation.

The Project is returning a famous but long blighted street to productive economic, social and cultural life and enhancing Times Square's stature as a national and international tourist destination. At full development, the Project entails a cost of $2.5 billion and contemplates 4.0 million square feet of office space, restoration of nine historic theaters, a merchandise mart, a hotel and arts-related retail space with corresponding jobs and revenues generated for the State and City.

Despite extended litigation, UDC has taken title to two-thirds of the thirteen acre development area by means of $240 million of funding provided by Prudential Insurance Company of America and Park Tower Realty, the prospective office developers for the Project. The property acquisition and subsequent elimination of blighting uses from the area has already improved the quality of life in in West Midtown; crime on the street has declined by 60%.

However, further progress is jeopradized by the currently unfavorable economics of most commercial development. In response, the developers have agreed to undertake a development which will rely upon the immediate introduction of low-rise, tourist and entertainment-related retail uses, rather than currently infeasible office tower construction. The Street will be brought back to life through private investment of more than $50 million, including more than $18 million towards the renovation of historic theatres on the Mid-block.

The State and City endorse this new approach as a rational response to a changed real estate maket and a creative alternative approach to the area's revitalization. While we remain committed to office development in the long term, deferring office construction means that substantial public benefits will flow now rather than depend upon an uncertain future revival of the Midtown office market.

In this light, and especially as we ask the developers to deepen their financial commitment in the midst of a persistent national recession, we are obliged to preserve the long term financial incentives which first attracted them.

To date, the developers have invested more than a quarter of a billion dollars in the Project: by any standard, an extraordinary expression of confidence in the City's future. We have reciprocated the developers commitment by reshaping the Project's development program to meet today's economic realities. We are doing what we can locally but Federal incentives remain key to moving the renewal forward without delay and to realizing the area's development potential.

The transition rules of the Tax Reform Act of 1986 provide specified tax treatments for properties within the Project if they are placed in service before January 1, 1998. The transition rules provide 19 1/2 year, 175% declining balance depreciation for real property; pre-1986 ACRS depreciation for personal property; an investment tax credit; amortization of leasehold improvements over the lease term when that is shorter than the useful life of the property; and pre-1986 amortization of construction period interest rather than capitalization of such interest.

These tax incentives were critical to attract the substantial private capital necessary for this pioneering and inherently risky commercial development. Their preservation is amply justified in light of the unforeseen turn in the market, the magnitude of the developer's investments and the substantial public benefits associated with this undertaking. Therefore, we urge that section 204(a)(1)(E) of the Tax Reform Act be amended to treat property as being placed in service by January 1, 1998 if at least $250 million was incurred or committed for development before April 15, 1993.

This amendment does not alter the scope of previously committed Federal Tax incentives and is revenue-neutral during the five year period used for Federal revenue estimates. Therefore, it appears consistent with larger policy, as well as local development goals, that the Federal commitment to the Project be re-affirmed as we suggest.

I thank you for your attention and look forward to your favorable consideration of this important initative.

Allegheny
ELECTRIC COOPERATIVE, INC.
212 LOCUST ST. P.O. BOX 1266 • HARRISBURG, PENNSYLVANIA 17108-1266 • PHONE 717 233-5704

July 19, 1993

The Honorable Charles Rangel
Chairman, Subcommittee on Select Revenue Measures
1105 Longworth House Office Building
Washington, DC 20515

Dear Chairman Rangel,

We strongly support the testimony offered by Bob Bergland, Executive Vice President of the National Rural Electric Cooperative Association, in favor of Representative Brewster's proposal to reaffirm a tax benefit enacted by Congress in 1981, called safe harbor leasing.

We are a so-called "generation and transmission" rural electric cooperative that provides at cost wholesale electricity to our fourteen member cooperatives, who in turn sell electricity to over 600,000 rural residents and businesses in Pennsylvania and New Jersey. Because the Internal Revenue service has spent the last few years flaunting congressional intent on this tax matter meant to spur economic growth during the recession of the early eighties, we fear the loss of this tax benefit--over a decade after we entered into a transaction which produces the tax benefits enacted by Congress.

For us and the families and businesses affected, this means:

- Eventual higher electric bills for rural families and businesses in predominately economically depressed areas.

- A degradation of the already questionable business climate in our rural areas.

- Difficulty for rural electric cooperatives in repaying loans to the Rural Electrification Administration.

It is important to note that the Congress has made some attempts to rein in the IRS as that agency has ignored the intent of Congress in this matter:

- Both the House and Senate have supported clarification of this issue in discussions of the 1989 conference report accompanying the Omnibus Budget Reconciliation Act.

- The Senate included a clarification provision in its version of the 1992 Tax Bill (HR 4210 and HR 11).

- The House Ways and Means and Joint Tax Committee technical staffs characterized this particular clarification as non-controversial last year.

We need your help now to rectify this situation. It is hard for us to understand how the IRS can arbitrarily take away a congressionally-mandated tax benefit upon which we have entered into long term business contracts and built our accounting for past years and many years to come. As Congress is working on new economic stimulus legislation, it is important to recognize that Congress must not allow the IRS to undermine, on an after-the-fact basis, past Congressional economic stimulus legislation or else businesses will be less likely to act on new economic stimulus programs for fear that the benefits are at risk.

Sincerely,

Ed Uravic
Manager of Federal Relations

CC: Janice Mays, Chief Counsel and Staff Director
Committee on Ways and Means

STATEMENT BY ROBERT L. MCPHAIL

GENERAL MANAGER, BASIN ELECTRIC POWER COOPERATIVE

BEFORE THE UNITED STATES HOUSE OF REPRESENTATIVES

SELECT REVENUE MEASURES SUBCOMMITTEE OF THE

HOUSE WAYS AND MEANS COMMITTEE

June 18, 1993

Basin Electric Power Cooperative is a member-owned and controlled wholesale supplier of 3,404 megawatts of electricity to parts of eight states: North and South Dakota, Montana, Wyoming, Colorado, Iowa, Minnesota, and Nebraska. Approximately 1.5 million consumers of Basin Electric receive power through the 128 member-systems operating in these states.

Basin Electric was incorporated in 1961 by a group of farmers and ranchers who had been informed by officials of the U.S. Department of Interior Bureau of Reclamation that the hydroelectricity generated at the dams located along the Upper Missouri River could not meet their needs in the future. The newly formed power supply cooperative established itself as a regional wholesale supplier in 1966 when its first generating unit came on line with an output of 220 megawatts. A robust economy of the 60s led to the addition of 460 megawatts being constructed along with additional transmission line facilities in 1975. In the early 70s, Basin Electric member cooperatives indicated their need for considerably more generating capacity to meet the electric needs of consumers in the 1970s and beyond. The national trend away from oil use and the rapidly growing electricity use created the need for additional generation in the late 1970s and into the early 1980s. Basin Electric was in a construction building mode for the first 20 years of its incorporation. Federal Financing Bank (FFB) and Rural Electrification Administration (REA) financing had been used in this effort to meet a regional necessity for electricity. At this point in Basin Electric's development, the use of safe harbor leasing was introduced as an option for financing additional electric generating facilities.

BACKGROUND:

From November 1981 through August 1983, Basin Electric Power Cooperative entered into nine separate safe harbor lease transactions (also called tax benefit transfers) in accordance with Section 168(f)(8) of the Internal Revenue Service (IRS) Code. These tax benefit transfers involved Laramie River Station Units 2 and 3 and related transmission facilities, the Antelope Valley Station Unit 1 and related transmission facilities, and several miscellaneous projects.

The ability to make these transactions was created under the Economic Recovery Tax Act of 1981 to benefit financially distressed companies such as Chrysler and U.S. Steel. These transactions were designed to give corporations that could not use their investment and energy tax credits and accelerated depreciation deductions the ability to sell the benefits to profitable corporations that could benefit. Subsequently repealed, these transactions also benefitted many rural electric generation systems.

In a tax benefit transfer, one party (the seller/lessee) sells an asset for tax purposes only to a second party (the buyer/lessor) and then leases the asset back. The sale takes place at cost with the buyer paying a down payment and giving a note of equal payments for the balance. The sale at cost has no immediate tax consequences, but as payments are made under the note the seller/lessee has income. However, the lessee rents the asset back for payments equal to the note payments, thereby providing the deduction for the rent. No cash changes hands after the initial down payment is made.

ISSUE:

During an audit of the safe harbor leases entered into by Western Farmers Electric Cooperative in Oklahoma, an IRS agent extended Section 277 of the IRS code to include cooperatives and safe harbor leases.

The effect of extending this section to safe harbor leases of cooperative could mean that cooperatives that have safe harbor leases could face much larger tax bills than ever intended even when the cooperative actually has a loss.

The IRS agent, based on a National Office Technical Advice memorandum issued December 13, 1991, has taken the position that interest income recorded by the seller/lessee received as part of the lease agreement will be treated as non-member income, but that the rent expense that should serve as a deduction will be allocated between the member and non-member sides of the business. This allocation is to be based on the proportionate shares of power purchased by the members and non-members.

Since the IRS has made a final determination in Western Farmers audit that this rent expense be split as both a member and non-member expense, great distortions will occur on Western Farmer's tax returns.

Mismatching the lease deductions and interest income creates large losses on the member side of the tax return, and an equal amount of income on the non-member side. Since the law requires cooperatives to separate their member and non-member business and generally pay taxes only on non-member net income, the cooperative cannot offset the losses and the income. Therefore, a cooperative could get taxed when it has as loss.

Example:

Member		Non-member	
		Interest Income	$70M
*Rent Expense	($28M)	**Rent Expense	($42M)
Loss	($28M)	Income	$28M
		Corp. Tax Rate	x34%
			$9.5M

*Members purchase 40%
**Non-members purchase 60%

POSITION:

Legal and accounting experts in taxation advised that taxable cooperatives were eligible to use safe harbor leases through the Economic Recovery Tax Act of 1981.

Based on consultations with these experts, Basin Electric and 14 other generation and transmission cooperatives entered into safe harbor leases during the years 1981-1983.

Cooperatives that used safe harbor leases reduced their use of the Rural Electrification Administration loan program and the Federal Financing Bank in accordance with Administration policy of increasing use of alternative financing.

Basin Electric supports clarification of this issue through a technical correction to Code Section 277. The correction would be that rent expenses would offset 100% of interest income and only the excess rent expense would be apportioned to members and non-members. Failure to clarify this issue will make power produced by cooperatives less competitive and increase the power bills of member-system consumers.

Congress never intended that the lessees would have long-term tax liabilities. These leases were set up to assist organizations that were financially distressed and no cooperative organization would have entered into these leases considering the future tax liabilities that this interpretation would cause.

The position concerning these transactions taken by the IRS in its audit of Western Farmers unfairly discriminates against cooperatives and would cause great financial distress to those participating cooperatives. This position if left to stand would serve to "change the rules in the middle of the game."

A letter encouraging a technical correction to Code Section 277 has been circulated in the past to Senators in the service areas of the cooperatives impacted. Basin Electric supports this and other efforts to fairly resolve this issue.

CONCLUSION:

Basin Electric has tried numerous times to resolve the issue of safe harbor leases. Basin Electric is requesting that the Select Revenue Measures Subcommittee of the House Ways and Means Committee support the enactment of legislation to be introduced by Representative Bill Brewster (D-OK). We believe this is a compromise position worthy of support by the House Ways and Means Committee.

WRITTEN STATEMENT OF
JOSEPH H. BERNEY
VICE-CHAIRMAN OF THE BOARD OF DIRECTORS
NATIONAL PRESTO INDUSTRIES, INC.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

My name is Joseph H. Berney and I am the Vice-Chairman of the Board of Directors for National Presto Industries, Inc. of Eau Claire, Wisconsin. I would like to thank the Committee for holding hearings on miscellaneous changes in the Internal Revenue Code and for specifically including the Accumulated Earnings Tax (AET) among the provisions to be considered during these hearings.

Further, Mr. Chairman, we recognize the incredible number of requests you have received for personal appearances and, in the interest of time, we have chosen to submit written testimony to you since we have appeared before the Committee previously on this topic.

Simply stated, we support the repeal of the AET [§532(c) of the Code] as it applies to widely held corporations. This proposal for simplification was submitted to the Committee in 1990 when it was included on page 861 of Ways and Means Committee Print 101-27 and, subsequently, in testimony before the Committee in 1991. Most recently, legislation to repeal the AET was introduced in the 103rd Congress by Representative Crane of Illinois as H.R. 663.

CREATION OF §532(c)

Section 532(c) of the Internal Revenue Code was enacted in 1984 solely in response to the growing popularity of the so-called "tax-managed corporation". A tax-managed corporation has no true business purpose. Rather, it was created to take advantage of the then-existing significant differential between capital gains tax rates and ordinary income tax rates.

A tax-managed corporation purchased a portfolio of dividend-paying stocks with its capital and, instead of paying dividends to its shareholders, accumulated the earnings it received from this portfolio. As a result, the value of the shares of stock in the tax-managed corporation increased in relative proportion to the dividend income it received from its portfolio.

Thus, shareholders did not pay taxes at ordinary income rates on the income resulting from their investment in the tax-managed corporation since the corporation paid no dividends. Instead, those shareholders paid taxes on that income at capital gains rates when they sold their shares in the tax-managed corporation. In many cases, this resulted in significant tax avoidance since the capital gains rate at that time was 20% whereas the top ordinary income rate was 50%.

These tax-managed corporations were widely-held to specifically avoid the imposition of the accumulated earnings tax. Accordingly, Congress created §532(c) in 1984 to apply the penalties associated with the accumulated earnings tax to these corporations for the first time. However, in doing so, Congress also exposed publicly-traded, widely-held corporations to the provisions of §532(c) - - a result that was never intended.

SUBSEQUENT TAX CHANGES MAKE §532(c) SUPERFLUOUS

The Tax Reform Act of 1986 equalized capital gains tax rates and ordinary income tax rates. Subsequent legislation has created a small and economically inconsequential differential between the two rates. Thus, the relationship between capital gains rates and ordinary income rates, by itself, prevents the creation and maintenance of tax-managed corporations from occurring under our current tax laws.

Section 532(c), therefore, should be repealed by Congress in its attempts to simplify the Internal Revenue Code because it is superfluous. Today, §532(c) serves only as an unwarranted intrusion into a publicly-traded, widely-held corporation's internal policy on growth and capital accumulation. As such, it represents a threat to the financial strength of widely-held operating corporations and, ultimately, to Federal revenues resulting from corporate activity.

IRS MISUSE OF §532(c) HAS LED TO JUDGMENTS AGAINST THE U.S.

We have warned the Committee for several years about the potential misuse of §532(c) by the Internal Revenue Service and the chilling effect this section of the Code has on the corporate business community. Notwithstanding our concern, the Department of the Treasury and some Congressional staff have repeatedly dismissed our apprehensions by maintaining it would be inappropriate and most unlikely that the IRS would apply §532(c) against publicly-traded, widely-held operating corporations.

Mr. Chairman, these concerns on behalf of widely-held operating corporations became a reality on February 18, 1993, when United States District Judge James M. Rosenbaum entered a judgment against the United States and in favor of Network Systems Corporation against whom the AET had been misapplied.

In his opinion granting summary judgment to the plaintiff in Network Systems Corp. v. United States of America, Case 4-91-CV-869 (Dis. MN), Judge Rosenbaum pointed out the fundamental flaw in the application of the AET to widely-held corporations when he noted:

> The IRS and the courts are ill-equipped to substitute their business judgment for that of the management and the investors in a market-oriented corporation. Corporate managers, who are presumably intimately familiar with their own industry and operations, are in a far better position to determine their capital needs than are federal tax examiners or judges.

Clearly, the time has come to repeal §532(c) of the Internal Revenue Code as it applies to widely-held corporations.

CLINTON ADMINISTRATION FAVORS AET CHANGES

Responding to an inquiry from Representative Crane concerning the Clinton Administration's position on §532(c), Secretary Bentsen supported revisions in the AET on May 12, 1993 when he noted:

> . . . [T]he Administration believes it is appropriate to revise the accumulated earnings tax. . . . It is possible that more clarity regarding safe harbors could reduce uncertainty about the application of the accumulated earnings tax. I would welcome any suggestions that you might have regarding appropriate clarification of the current rules.

Accordingly, we believe that it is most appropriate for the Committee to consider the repeal or modification of §532(c) at this time.

POTENTIAL SAFE HARBORS IN LIEU OF REPEAL

While we continue to favor the outright appeal of the AET as it applies to widely-held corporations, we would not oppose the retention of §532(c) if an acceptable safe harbor to the AET could be constructed as suggested by Secretary Bentsen.

Such an acceptable safe harbor would be an exemption for widely-held corporations that derive only a nominal percentage (e.g., 10%) of their income from securities subject to the seventy percent dividends received deduction. Other possible safe harbors could include: (1) an exemption for publicly-traded, widely-held corporations which have a history of increasing dividends on an annual or regular basis; or (2) an exemption for publicly-traded, widely-held corporations which pay 50 percent of more of their annual earnings in dividends.

We would be pleased to work with the Committee and its staff in the development of an appropriate safe harbor in the event that the outright repeal of §532(c) does not occur.

CONCLUSION

Because §532(c) is no longer a functioning portion of the Internal Revenue Code and is, in fact, being misapplied by the Internal Revenue Service in a way that is costing the United States Treasury millions of dollars in damages, it is respectfully requested that the Committee include the repeal of §532(c) in any upcoming legislation addressing miscellaneous revenue changes.

In the event that the AET cannot be repealed, it is respectfully submitted that the Committee construct one of the safe harbors suggested by this statement to protect widely-held American corporations from future unwarranted intrusions into their internal policies on growth and capital accumulation.

Again, thank you for the opportunity to submit written testimony to you on this important revenue issue.

June 30, 1993

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22209-2022

(703) 524-3636
Fax (703) 524-2303

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Washington, D. C. 20515

Dear Mr. Chairman:

The National Staff Leasing Association (NSLA) is the recognized trade association for the staff leasing industry. For years, the NSLA has been known as the leading standards-setting organization for the industry, and its members have enjoyed a reputation for honest and ethical business practices. The NSLA's strict code of ethics and business conduct is one of the finest examples of industry self-regulation. For example, "accredited" members must go the extra mile by providing NSLA with quarterly verification by independent accountants attesting that its fiscal responsibilities have been properly discharged for payroll taxes and employee benefits.

The NSLA would like to go on record as opposed to the proposal which would "add a new safe harbor plan under the leased employee rules and make certain changes to the rules," as contained in the **miscellaneous tax proposals**.

The NSLA's opposition is due primarily because of the emphasis on sole employer versus co-employer. The determination of whether an employee leasing organization is the sole employer or is a co-employer should be based on a factual evaluation of operations based on principles of common law. The NSLA does not support the definitions of a "qualified leasing organization" or the criteria to designate a leasing organization as the "sole employer" contained in the proposed legislation. These criteria obviously have been drafted to satisfy a specific company's interest and are not reflective of the approved definitional criteria established by the NSLA or reflective of the operations of the majority of our industry.

Thank you for allowing the NSLA the opportunity to comment on this proposal.

Sincerely,

Rob Lederer
Executive Director

SIERRA SEMICONDUCTOR

STATEMENT OF JAMES V. DILLER,

PRESIDENT AND CEO FOR SIERRA SEMICONDUCTOR CORPORATION

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

JUNE 22, 1993

Mr. Chairman and Members of the Committee. My name is James V. Diller and I am President and CEO of Sierra Semiconductor Corporation (Sierra). I respectfully submit this written statement on behalf of our company. As a member of the American Electronics Association, we are asking for your help in seeking legislative relief from what we believe to be an unintended result of the 1990 research credit changes.

Sierra is a leading supplier of high performance mixed signal integrated circuits for the personal computer and personal communications markets. The Company's products reduce the size and expense of electronic systems, while increasing their reliability and performance, by integrating many analog and digital functions in a single semiconductor. Sierra's mixed signal products are fundamental components of data and facsimile modems, disk drives and color display systems.

Our Early Success Leads to Lost Research Credits

Formed in November, 1983, Sierra experienced rapid growth during its start-up phase. From 1984 to 1985, research spending more than doubled. Our first product was introduced in 1986. Sales were $8 million that year, reaching more than $61 million in 1990, our first full year of profitability. On the strength of those results and our outstanding prospects for the future, Sierra had a successful initial public offering in April, 1991. Since then, both sales and profits have increased dramatically, while maintaining our annual research investment at an aggressive 14 to 19 percent of sales.

During the critical period of 1984 to 1988, our average percentage of qualified research expenses to sales was 29 percent. We failed to qualify as a "start-up company" for purposes of special base period relief because we had more than *de minimis* sales from our first product launch in the third year of the base period (see Exhibit 1). Our fast ramp in sales has cost us significantly more in lost tax incentives than the profits from those early sales.

Tax Law Revisions Fail to Encourage All Start-Up's

The statutory maximum 16 percent fixed base period percentage in the expired research credit provisions does nothing to improve our chances of claiming a research credit in the foreseeable future. Sales growth in recent years has been explosive. Applying the 16 percent fixed base percentage to a moving average of our four prior years' sales sets the hurdle just beyond our reach in each successive year. As a result, under the research credit as extended permanently in the House Reconciliation Bill, Sierra would get no credit ever. Therefore, the credit's incentive value is zero for a few companies like Sierra, which were truly "start-up companies" during the base period but which technically fail to meet the definition. As far as I am concerned, that represents a failure of the research credit's design.

The barriers to entry in the mixed signal business are high, a factor which has contributed greatly to Sierra's success. We need to continue to introduce new products like multimedia, graphics and advanced communication devices, or these same barriers could contribute to our decline, especially given strong challenges from abroad. Assembling a world class design team equipped with state-of-the-art test equipment requires a vast amount of capital. We are committed to spending heavily for research to stay competitive, but the research credit as currently designed for start-up companies will not encourage us to spend even one dollar more.

Competitive Disadvantage at a Critical Point for Sierra

Side-by-side comparison to other public companies in our industry illustrates our issue most vividly (see Exhibit 2). We share the same high growth characteristics as these companies yet we do not share in the available research credits, putting us at a direct disadvantage. This comes at a point for us when technologies must be developed so that exciting new products can replace the mature products that drove much of our past growth. We cannot believe that the Congress intended to arbitrarily deny the credit to successful companies like Sierra and a few others who were unfortunate enough to have their first year of both research expense and sales fall within 1984, 1985 or 1986.

Conclusion

Legislative relief is necessary to also include any company having its first year of both sales and research expenditures in the years 1984, 1985 or 1986 under the start-up company definition. Indeed it was included in the tax bill last year (H. R. 11), which later was vetoed by President Bush. We urge the Congress to review this issue and to take action now on behalf of the companies whose situations apparently were overlooked during the struggle over bigger issues in the 1990 research credit revisions.

EXHIBIT 1 - SIERRA SEMICONDUCTOR RESEARCH CREDIT FOR 1991 (1992 TAX RETURN NOT YET AVAILABLE)

SIERRA'S FIXED PERCENTAGE:

	YEAR ENDED	QUALIFIED R & D EXPENSES	SALES BY U.S.
	1984	2,532,651	0
	1985	6,516,676	0
	1986	3,292,549	7,853,664
	1987	4,822,860	23,137,174
	1988	5,256,006	46,050,465
TOTALS		22,420,742	77,041,303
PERCENTAGE		29.10%	
NOT TO EXCEED		**16.00%**	

AVERAGE ANNUAL SALES BY U.S. FOR 4 PRECEDING TAXABLE YEARS:

1987	23,137,174
1988	46,050,465
1989	42,252,499
1990	55,574,088
1991	
TOTAL	167,014,226
AVERAGE	41,753,557

THE COMPUTATION:

QUALIFIED R & D EXPENSES*	5,885,801
AVERAGE ANNUAL SALES	41,753,557
TIMES FIXED PERCENTAGE	16.00%
BASE AMOUNT	6,680,569
INCREMENTAL (SHORTFALL) OVER BASE AMOUNT	(794,768)
R & D CREDIT	**0**

*QUALIFIED R & D AS PERCENT OF TOTAL RESEARCH EXPENSE IS APPROXIMATELY 50 PERCENT DUE TO DEPRECIATION OF HIGH DOLLAR DESIGN EQUIPMENT AND DESIGN ROYALTIES NOT ELIGIBLE FOR THE RESEARCH CREDIT. THE PERCENTAGE IS ROUGHLY COMPARABLE TO OTHER SEMICONDUCTOR COMPANIES.

EXHIBIT 2 - COMPARATIVE 1991 RESEARCH SPENDING AND CREDITS

(IN 000'S)

COMPANY	SIERRA	INTEL	CIRRUS LOGIC*	BROOKTREE**	EXAR*	XILINX*	ZILOG	ALTERA
NET REVENUES	$85,933	$4,778,616	$141,840	$83,417	$112,730	$97,638	$110,078	$106,862
R&D EXPENSE	$12,510	$618,048	$22,655	$17,691	$9,570	$12,431	$11,972	$14,381
PERCENTAGE	14.56%	12.93%	15.97%	21.21%	8.49%	12.73%	10.88%	13.46%
PRETAX PROFIT	$14,612	$1,194,629	$29,081	$13,068	$11,450	$25,723	$15,470	$27,845
R&D CREDIT	**$0**	**$11,900**	**$1,454**	**$1,360**	**$708**	**$409**	**$203**	**$174**

*FISCAL YEAR ENDED 3/91
** FISCAL YEAR ENDED 9/91

NOTE: THIS INFORMATION IS EXCERPTED FROM ANNUAL REPORTS AND REPRESENTS THE RESEARCH CREDITS WHICH REDUCED TAX EXPENSE IN THE PERIOD. ACTUAL RESEARCH CREDITS EARNED IN 1991 FOR COMPARATIVE COMPANIES MAY BE DIFFERENT DUE TO CARRYFORWARD UTILIZATION OR LIMITATIONS, FOR EXAMPLE. SIERRA HAS UNUSED RESEARCH CREDIT CARRYFORWARDS EARNED UNDER PRE-1990 LAW.

AMERICAN BAKERS ASSOCIATION

Paul C. Abenante
President and CEO

September 8, 1993

The Honorable Charles Rangel
Chairman
Select Revenues Subcommittee
Committee on Ways and Means
1100 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rangel:

As President of the American Bakers Association, a trade association representing nearly 90 percent of the nation's wholesale baking industry, I am writing in support of a proposed change in the Internal Revenue Code Section 3121 (d) (3) (A) eliminating the term "bakery products,".

Section 3121 (d) (3) (A) of the Internal Revenue Code states that certain specified individuals will be treated as employees for purposes of Social Security (FICA) taxes -- even though those individuals are not employees under the usual common law rules. This provision was originally included in the Code by the Social Security Act Amendments of 1950. Later, an amendment to the Code provided that these individuals be treated as employees for Federal Unemployment Tax (FUTA) purposes. At that time, Congress explicitly recognized that those individuals may not be employees under the usual common law rules, but nonetheless determined that the individuals "should be taxed at the employee rate under the old-age, survivors and disability program."

Much has changed since the Congress implemented this change in 1950. There exists no reason for this special treatment of those "engaged in distributing bakery products". The self-employment tax currently equals the combined employer-employee FICA tax. Therefore, the concern Congress had in 1950 no longer exists.

Secondly, bakery products are no longer delivered house-to-house by delivery persons. Bakery products are often distributed by individuals who own distributorship operations who purchase and sell bakery products to commercial customers such as retailers and other wholesalers.

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The wholesale baking industry is not seeking preferential treatment for those whom distribute bakery products. Rather Section 3121 (d) (3) (A) has no basis for application in the modern wholesale baking business. In our view, this simple change is revenue neutral and would simply mean that distributors of bakery products would now be subject to the same rules that apply to distributors in other industries.

Thank you for the opportunity to express our position on this important matter. Please feel free to contact me if you have any questions or need additional information.

Sincerely,

Paul C. Abenante

PAUL C. ABENANTE
President and Chief Executive Officer

PCA/kmb

Robert G. Petersdorf, M.D.
President

AAMC

ASSOCIATION OF
AMERICAN
MEDICAL COLLEGES

2450 N STREET, NW
WASHINGTON, DC 20037-1126
TELEPHONE (202) 828-0460

September 15, 1993

The Honorable Charles B. Rangel
Chairman
Select Revenue Measures Subcommittee
House Ways and Means Committee
1105 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

The Association of American Medical Colleges would like to submit the following statement for the September 8, 1993 hearing record to accompany the testimony of Stanley W. Rosenkranz, Esquire, on behalf of the Florida Clinical Practice Association, the University of Florida Agency Funds and the University of South Florida College of Medicine's Faculty Practice Plan.

The leadership of the College of Medicine at the University of Florida (the "University") has called to our attention a significant financial problem that it is attempting to solve on both the administrative and legislative fronts.

As we understand the situation, medical school clinical faculty members at the University, as well as those at the University of South Florida, are employed pursuant to one contract. The agreed upon compensation, however, emanates from two sources -- a state warrant and a check drawn on the University Agency Account (singularly a "Source"; collectively the "Sources"). The latter account receives the income for the professional services of the clinical faculty by transfer from the College's faculty group practice plan. From these two sources, the medical school clinical faculty are paid the total salary.

As required by the Internal Revenue Service, each Source withholds the maximum amount of FICA from each compensation payment effected by it and pays, in connection with each such payment, the maximum FICA payment required of an employer. Thus, "double FICA" payments are made. The faculty members can easily recoup the excess FICA payments. However, the employer cannot recoup such monies. Each of the Sources also files its own Form 941 and Form W-2.

Section 125(a) of Public Law 98-21 was enacted to address such situations at medical schools throughout the nation which experienced the problem outlined above. Unfortunately, because of a unique quirk in Florida law, the two Florida universities having public medical schools cannot configure the employment arrangement to comport with the requirements of Section 125(a). The aggregate annual cost to both schools exceeds $3 million. Such monies, of course, would otherwise be available for teaching and research, as well as for support for the delivery of health care services to patients who are unable to pay for professional medical care.

Understandably, the Florida universities do not desire to seek an administrative solution on an annual basis. For this reason, we are told, they are seeking a legislative solution in the form of an amendment to Section 125(a) of Public Law 98-21.

I believe the revenue impact of the proposed legislative amendment would be limited to the excess employer share of FICA taxes currently being paid. Assuming no increase in the FICA tax rate such impact on revenue should not exceed $3 million annually over the next few years. Again, these funds would otherwise be available for teaching and research, as well as for support for the delivery of health care services to patients unable to pay.

Any assistance you and the members of the Select Revenues Subcommittee can provide in this situation would be very much appreciated.

Very sincerely yours,

Robert G. Petersdorf

Robert G. Petersdorf, M.D.

STATEMENT BY ROBERT J. MYERS PRESENTED TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, WITH REGARD TO MISCELLANEOUS REVENUE ISSUES.

Mr. Chairman and Members of the Subcommittee: My name is Robert J. Myers. I served in various actuarial capacities with the Social Security Administration and its predecessor agencies during 1934-70, being Chief Actuary for the last 23 of those years. In 1981-82, I was Deputy Commissioner of Social Security, and in 1982-83, I was Executive Director of the National Commission on Social Security Reform. In 1983-85, I was Chairman of the Railroad Unemployment Compensation Committee, and in 1987-90, I was Chairman of the Commission on Railroad Retirement Reform.

My testimony will relate only to H.R. 931, the Social Security Investment Certification Act of 1993, which was introduced by Congressman Andy Jacobs on February 17, 1993. I strongly support the underlying intentions of this bill and hope that it will be enacted.

In brief, H.R. 931 would require that all investment of the Old-Age and Survivors Insurance and Disability Insurance Trust Funds should be in the traditional form of a certificate (i.e., a visible "hard" copy). Such certificate would state the face amount, the interest rate payable, the maturity date, and the terms under which it can be redeemed before the specified maturity date (i.e., at par), as well as the customary language as to the obligation being supported by the full faith and credit of the United States (as to payment of both interest and principal).

For many years, the assets of the trust funds were invested in obligations which were of the traditional type -- in fact, at some times, in coupon bonds. Visible evidence of this can be found in a picture in my autobiography, "Within the System -- My Half Century in Social Security" (ACTEX Publications, Winsted, CT, 1992, page 237), where the Board of Trustees is shown examining such bonds in 1968. In recent years, as public issues have ceased to be in hard-copy form, the same book-entry procedure has been followed for new investments of the trust funds.

I believe that confidence in the financial viability of the Social Security program would be improved and maintained if its investments were in hard-copy form as H.R. 931 would provide. The general public would then, with such visible evidence properly publicized, realize the full validity of the program's current assets -- instead of believing that no assets are present, but rather at best only intangible, unwritten IOU's.

Of course, from actuarial, budget, and fiscal standpoints, this change in procedure would make no real difference. The actuaries of the Social Security Administration, in making valuations of the program, quite properly consider the existing book-entry assets as completely valid, both as to paying interest and as to the principal being fully available at redemption. No significant cost would occur to the trust funds or the government if this small, but significant, change in the investment procedure is made. And, just as at present, detailed listings of the investments would be available in such places as the annual Trustees Reports.

There is one additional thing along the lines of what H.R. 931 is attempting to do that I believe would be desirable. All financial transactions between the Department of the Treasury and the several trust funds should be by check, just as is done when persons who hold government obligations in paper form receive their interest payments or their return of principal at maturity.

Specifically, the interest payments on the certificates required by H.R. 931 would be paid by check from the Department of the Treasury to the Managing Trustee, who would then handle it just as the Internal Revenue Service does in connection with checks for Federal Insurance Contributions Act taxes from employers. The same process would be followed for the proceeds when such certificates are redeemed by the trust funds -- either at maturity or prior thereto. If the foregoing procedure were prescribed, the public would better understand the reality and validity of the trust-fund investments -- and would not believe that they are like an individual writing himself (or herself) an IOU.

TESTIMONY

SUBMITTED BY JOE MOAKLEY (D-MA)

TO HOUSE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON TAXATION

SEPTEMBER 8, 1993

Thank you for holding hearings on H.R. 2603, legislation that my colleague Rep. Richard Neal (D-MA) and I introduced on July 1, 1993. The purpose of the legislation is to amend Federal tax laws to permit a non-profit student loan funding corporation to transfer its student loan assets and outstanding debt to a for-profit, taxable corporation.

Mr. Larry O'Toole, President and Chief Executive Officer of NELLIE MAE, will testify in support of these tax changes. NELLIE MAE, located in my Congressional District, is the largest of the 23 nonprofit student loan funding corporations which serve as regional secondary markets for lenders originating loans under the federal student loan program. Under current law, NELLIE MAE is able to issue tax-exempt debt to finance the acquisition of student loans as long as their earnings are reinvested into student loans. NELLIE MAE has demonstrated its ability to administer the Federal student loan program effectively and would like to continue to do in the future.

As a result of the modification to the Federal student loan program, NELLIE MAE and the other regional secondary market corporations have indicated many lenders involvement in the Federal student loan program would be limited. Lenders would not be inclined to commit resources to a winding down program or a continued program if the financial incentives are reduced. H.R. 2603 would enable NELLIE MAE and other secondary markets corporations to increase the level of funding for student loans in order to make up for any reduction or withdrawal of lending institutions during the phase-out period. Simply, NELLIE MAE will be able to raise enough capital to continue to service student loans during the transition to a new Federal direct loan program.

The legislation has been modified to balance the needs of non-profit student loan funding corporations with the goals of Federal education policy. I believe that this legislation is a reasonable approach that will ease the transition to a direct loan program. I respectfully request that you give this legislation your utmost consideration. Thank you again for holding hearings on this legislation.

RICHARD E. NEAL
SECOND DISTRICT, MASSACHUSETTS

WHIP AT LARGE

COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON TRADE
SUBCOMMITTEE ON SELECT REVENUE MEASURES

Congreſs of the United States
House of Representatives
Washington, DC 20515

September 15, 1993

STATEMENT OF MR NEAL
SUBCOMMITTEE ON SELECT REVENUE
SEPTEMBER 8, 1993 HEARING ON MISCELLANEOUS REVENUE ISSUES

Mr. Chairman, I want to thank you for addressing H.R. 2603 as part of the hearings being held by the Subcommittee on Select Revenue Measures. On July 1, 1993 Chairman Moakley and I introduced H.R. 2603. The legislation would amend the Internal Revenue Code of 1986 to provide transition relief for nonprofit student loan funding corporations.

The recently passed Omnibus Budget Reconciliation Act of 1993 included the Student Loan Reform Act of 1993 which altered the current system of funding for student loans. Under this legislation, a new direct federal loan program will be phased-in over the next four years. Due to the changes caused by this legislation, a change is needed to the tax code to allow scholarship funding corporations to continue to assist with the funding of student loans.

There are twenty-one scholarship funding corporation across the country which provide secondary market support and services in the federal student loan programs. These corporations, described in Internal Revenue Code Section 150 (d), are permitted to issue tax -exempt debt to finance acquisitions of student loans so long as their earnings are reinvested in student loans. Most of these nonprofit have financed student loan acquisitions with both taxable and tax-exempt debt. These organizations are defined as 501 (c) (3) organizations by the Internal Revenue code and therefore, they are not permitted to raise equity capital from private investors.

Nonprofit student loan funding corporations desire to serve the capital need for student loans, but need tax law changes to enable them to raise the needed capital. Specifically, they need the ability to transfer their assets and including tax-exempt debt, to a for-profit taxable corporation in exchange for a stock interest in such a "conversion corporation." This transfer will allow the conversion corporation to raise equity capital.

I am pleased that this issue has the opportunity to be debated. Also, I look forward to the testimony of Lawrence O'Toole, the President and CEO of the New England Education Loan Marketing Corporation.

ACTEC

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September 23, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Subcommittee on Select Revenue Measures September 23, 1993 Hearing
Proposal to Modify Generation-Skipping Tax Predeceased Parent Exception

Dear Ms. Mays:

I am the President of the American College of Trust and Estate Counsel and am writing on its behalf. I am writing to urge you to expand the predeceased parent exclusion under IRC Section 2612(c)(2). This exclusion currently applies only to direct skips and not taxable terminations or taxable distributions. The exclusion applies to exempt what would otherwise be a direct skip to a descendant of the transferor when the parent of the recipient who also is a descendant of the transferor is deceased at the time of the transfer. We believe that the exclusion should be expanded to two additional areas described below.

Expansion to Descendants of Transferor's Grandparent.

The exclusion presently applies only to direct skips to a lineal descendant of the transferor. For example, a gift to a grandchild of the transferor is not a direct skip if the grandchild's parent who is the child of the transferor is deceased at the time the transfer is made. If the transferor's will gives his or her property outright to nieces and nephews, with any share for a deceased niece or nephew to pass to the deceased nieces' or nephews' descendants, per stirpes, any property passing to a grandniece or grandnephew is a direct skip and thus subject to generation-skipping tax at the maximum transfer tax rate. Nonetheless, no tax avoidance has occurred because the distribution is made to the skip person only because his or her parent has predeceased the transfer. Because no tax avoidance can be planned for in this case, the exception should apply.

A direct skip is a transfer subject to estate or gift tax to a skip person. A skip person is someone two or more generations younger than the transferor. Generation assignments are provided in IRC Section 2651. Individuals are assigned to a generation under the family assignment rules or, if not assigned under those rules, by their ages relative to the transferor. The family assignment rules assign any individual who is a lineal descendant of a grandparent of the transferor or of the transferor's spouse, and any individual married to such a descendant, according to family generation lines. Thus the predeceased parent exception could be extended to apply to any individual assigned under the family assignment rules of IRC Section 2651(b)(c). In such case any transfer to a skip person assigned under those rules would not be a direct skip if all of the ancestors of the individual who are descendants of the grandparent of the transferor or of the transferor's spouse (other than those assigned to the transferor's generation) are deceased at the time of the transfer. If an individual is assigned under the family rules because of marriage to a descendant of a grandparent of the transferor or of the transferor's spouse, the rule would apply to a transfer to that individual if all of the ancestors of such married descendant who were lineal descendants of the grandparent of the transferor or of the transferor's spouse (other than those assigned to the transferor's generation) are deceased at the time of the transfer.

Apply the Exception to Some Taxable Terminations and Distributions

The second area where the predeceased parent exception should be changed is to extend the exclusion to taxable terminations and taxable distributions in some cases.

Example 1. Assume that T creates a non-marital deduction trust at T's death exclusively for T's spouse, S, for life, remainder to T's descendants, per stirpes, who are living at S's death, and that T's only child, C, dies before S, leaving a child, GC, surviving. GC will receive the entire trust outright on S's death. This transfer to GC will not qualify for the predeceased parent exclusion because the distribution to GC at S's death will be a taxable termination and not a direct skip.

Example 2. Assume that T creates a charitable lead trust for ten years at the end of which time the trust is distributed per stirpes to T's then living descendants, and that one of T's children, C1, is deceased at the time the charitable lead trust is created, but was survived by a child, GC1. A distribution to GC1 at the end of the ten-year term will be a taxable termination and not a direct skip and thus will not qualify for the predeceased parent exception.

Example 3. Assume that at T's death, T creates a trust that sprays income and principal among all of T's descendants until the youngest child reaches age 25, at which time the trust distributes outright per stirpes to T's then living descendants. Assume one child of T is alive, C1, age 22, and one child, C2, is deceased at T' death, and that C2's child, GC2, survives T. Under the current predeceased parent exception, the transfer to the trust would not be a direct skip. Any distributions to GC2 would be taxable distributions. On the termination of the trust, the portion passing to GC2 would be subject to generation-skipping tax as a taxable termination.

All three results seem wrong because the child is not being skipped for a tax avoidance motive. If the lack of tax avoidance motive in these cases is recognized if a direct skip is made, why not for these other taxable transfers?

We believe that one method of solving these problems would be to apply the predeceased parent exception to move up the generation of a skip person to the level of his or her parent if the parent has predeceased the death of the last to die of the transferor or the transferor's spouse (or former spouse). However, we believe that this move up rule should apply with respect to a particular trust only if the predeceased parent never had an interest as defined in IRC Section 2652(c) in the trust before the taxable transfer occurred. In Example 1, C never had an interest in the trust during S's life. C predeceased the death of the last to die of T and S and so GC's generation would be moved up to C's generation if the predeceased parent exception is changed as described above. In Example 2, GC1 would be moved up to C1's generation and no generation-skipping tax would be imposed on the distribution to GC1. In Example 3, the rule would operate to move GC2's generation up to the level of C2. Thus distributions to GC2 would not be taxable distributions and the distribution of the trust when C1 reaches age 25 would not be a taxable termination.

We urge Congress to expand the exception as described above to promote greater fairness and easier administration of the generation-skipping tax for both practitioners and the government.

Sincerely,

James M. Trapp

James M. Trapp

September 23, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Subcommittee on Select Revenue Measures September 23, 1993 Hearing Proposal to Modify Generation-Skipping Tax Predeceased Parent Exception

Dear Ms. Mays:

The undersigned, who are officers, council members, committee chairs and members of the Real Property, Probate & Trust Section of the American Bar Association but who are writing solely as individuals in their individual capacities and not on behalf of the section or the American Bar Association, wish to submit the following comments and suggestions with respect to the generation-skipping tax predeceased parent exception. We are writing to urge you to expand the predeceased parent exclusion under IRS §2612(c)(2). This exclusion currently applies only to direct skips and not taxable terminations or taxable distributions. The exclusion applies to exempt what would otherwise be a direct skip to a descendant of the transferor when the parent of the recipient who also is a descendant of the transferor is deceased at the time of the transfer. We believe that the exclusion should be expanded to two additional areas described below.

1. Expansion to Descendants of Transferor's Grandparent.

The exclusion presently applies only to direct skips to a lineal descendant of the transferor. For example, a gift to a grandchild of the transferor is not a direct skip if the grandchild's parent who is the child of the transferor is deceased at the time the transfer is made. In contrast, if the transferor's will gives his or her property outright to nieces and nephews, with any share for a deceased niece or nephew to pass to the deceased nieces' or nephews' descendants, per stirpes, any property passing to a grandniece or grandnephew is a direct skip and subject to generation-skipping tax at the maximum transfer tax rate. Nonetheless, no tax avoidance has occurred because the distribution is made to the skip person only because his or her parent has predeceased the transfer. Because no tax avoidance can be planned for in this case, the exception should apply. No reason exists for treating direct skips to collateral relatives more harshly than direct skips to descendants.

A direct skip is a transfer subject to estate or gift tax to a skip person. A skip person is someone two or more generations younger than the transferor. Generation assignments are provided in IRC Section 2651. Individuals are assigned to a generation under the family assignment rules or, if not assigned under those rules, by their ages relative to the transferor. The family assignment rules assign any individual who is a lineal descendant of a grandparent of the transferor or of the transferor's spouse, and any individual married to such a descendant, according to family generation lines. Thus, the predeceased parent exception could be extended to apply to any individual assigned under the family assignment rules of IRC Section 2651(b) and (c). In such case any transfer to a skip person assigned under those rules would not be a direct skip if all of the ancestors of the individual who are descendants of the grandparents of the transferor or of the transferor's spouse (other than those assigned to the transferor's generation) are deceased at the time of the transfer. If an individual is assigned under the family rules because of marriage to a descendant of a grandparent of the transferor or of the transferor's spouse, the rule would apply to a transfer to that individual if all of the ancestors of such married descendant who were lineal descendants of the grandparent of the transferor or of the transferor's spouse (other than those assigned to the transferor's generation) were deceased at the time of the transfer.

2. Apply the Exception to Certain Taxable Terminations and Distributions

The second area where the predeceased parent exception should be changed is to extend the exclusion to taxable terminations and taxable distributions in some cases.

a. Person Predeceases Trust Creation

Example 1. Assume that T creates a trust at T's death for T's spouse, S, for which a marital deduction is not allowed. The trust provides income to S for life, remainder to T's descendants, per stirpes, who are living at S's death, and that T's only child, C, dies before T, leaving a child, GC, surviving. GC will receive the entire trust outright on S's death. This transfer to GC will not qualify for the predeceased parent exclusion because the distribution to GC at S's death will be a taxable termination and not a direct skip.

Example 2. Assume that T creates a charitable lead trust for ten years at the end of which time the trust is distributed per stirpes to T's then living descendants, and that one of T's children, C1, is deceased at the time the charitable lead trust is created, but was survived by a child, GC1. A distribution to GC1 at the end of the ten-year term will be a taxable termination and not a direct skip and thus will not qualify for the predeceased parent exception.

Example 3. Assume that at T's death, T creates a trust that sprays income and principal among all of T's descendants until T's youngest child reaches age 25, at which time the trust distributes outright per stirpes to T's then living descendants. Assume that T has two children living, C1 and C2, when T executes T's estate planning documents, and that at T's death, C1 is age 22 and C2 is deceased with a child, GC2, then living. Under the current predeceased parent exception, the transfer to the trust would not be a direct skip. Any distributions to GC2 would be taxable distributions. On the termination of the trust when C1 reaches age 25, the portion passing to GC2 would be subject to generation-skipping tax as a taxable termination.

All three results seem wrong because the deceased child is not being skipped for a tax avoidance motive. The child is being skipped because he or she is dead. If the lack of tax avoidance motive is recognized if a direct skip is made, why not for these other taxable transfers?

We believe that one method of solving these problems would be to expand the predeceased parent exception to move up the generation of a skip person to the level of his or her parent for taxable terminations and taxable distributions with respect to a trust if the skip person's parent has predeceased the creation of the trust. For this purpose, the creation of the trust would be the last time the transfer creating the trust was subject to federal estate or gift tax.

b. Person Predeceases Last to Die of Transferor and Spouse

The expansion of the predeceased parent exception as described above will solve the problems described in examples 1, 2 and 3 when a child dies before the person creating the trust and should be adopted regardless of whether any further expansion of the predeceased parent exception is made. In addition, however, other problems exist because of the limited nature of the exception that could be solved if the predeceased parent exception were expanded even further.

Example 4. Assume that T creates a trust at T's death for T's spouse, S, for which a marital deduction is not allowed. S is the sole beneficiary for life with remainder to T's descendants, per stirpes, who are living at S's death. Assume further that T's only child, C, dies after T but before S, leaving a child, GC, surviving. GC will receive the entire trust outright on S's death. This transfer to GC will not qualify for the predeceased parent exclusion because the distribution to GC at S's death will be a taxable termination and not a direct skip. In addition, the expansion described under a. above will not solve this problem because C did not die before the taxable transfer creating the trust.

This type of problem would occur with regard to trusts where T's GST exemption available or allocated is insufficient to exempt the entire trust, such as irrevocable insurance trusts, charitable lead trusts, non-marital trusts for spouses, and QTIP trusts for which a reverse QTIP election (under Sec. 2652(a)(3)) is made.

Example 5. Assume that T creates a qualified personal residence trust (QPRT) for ten years at the end of which time the QPRT is distributed per stirpes to T's then living descendants, and that one of T's children, C1, is alive at the time the trust is created, but dies survived by a child, GC1, before the end of the ten year term. Assume that T is alive at the end of the ten-year term. A distribution to GC1 at the end of the ten-year term will be a taxable termination and not direct skip and thus will not qualify for the predeceased parent exception. The expansion described under a. above will not solve this problem because C did not die before the taxable transfer creating the trust.

The predeceased parent exception should apply to both of these examples to exempt the transfer to the grandchild from tax. In both examples, the child is not skipped for any tax avoidance motive and no splitting of benefits between generations took place. In example 5, the unfairness of treating the termination of the retained interest as a taxable termination is increased because the trust is subject to an ETIP (estate tax inclusion period) under § 2642(f)that results in T's inability to effectively allocate GST exemption until the retained interest ends. Because the GST allocation rules treat the transfer as "incomplete" until the retained interest ends, the predeceased parent rule should correspondingly treat the termination in favor of a grandchild no worse than an outright transfer to a grandchild at the end of the term.

We believe that a simple way to solve these problems is to apply the predeceased parent exception to move up the generation of a skip person to the level of his or her parent if the parent has predeceased the death of the last to die of the transferor or the transferor's spouse (or former spouse). This rule makes sense because the estate and gift tax system allows property to pass without tax between married persons. This change to the exception would remove any difference relating to who established the trust. However, we believe that this move up rule should apply only if the predeceased parent never had an interest as defined in IRS §2652(c) in the property before the taxable transfer occurred. In Example 4, C never had an interest in the trust during S's life. C predeceased the death of the last to die of T and S and so GC's generation would be treated as if in C's generation if the predeceased parent exception is changed as described above. In Example 5, C1 predeceased the death of the last to die of T and S, and so GC1 would be moved up to C1's generation and no generation-skipping tax would be imposed on the distribution to GC1.

We believe that the changes described above would result in greater fairness and easier administration of the tax for both practitioners and the government. In some of the examples, but not all, sophisticated planning can solve the problem described, creating a trap for the unwary in these cases and inconsistent application of the tax laws to persons similarly situated. We urge you to support these changes.

Thank you in advance for considering our views.

Very truly yours,

Carol A. Harrington /swb

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Office of the President

September 21, 1993

Chairman
Subcommittee on Select Revenue Measures
Committee on Ways and Means

Mr. Chairman:

I am the President of Maryville University, a school of approximately 4,000 students located in St. Louis County, Missouri. I have been involved in the administration and financial workings of higher education for twenty years in colleges and universities in Texas, Pennsylvania, Colorado and Missouri. We face a constant challenge to finance our schools. It is well known that the tuition charges only pay a fraction of the true cost of operating a university. So we need extra financial support not only to make ends meet in our everyday operations, but especially to enhance the quality of the educational experience we can offer our students.

Maryville is and expects to continue to be the beneficiary of charitable trusts. These sources of support have directly helped us add a new gymnasium and library to our campus among other things.

I am not a tax expert; however, I have been advised that due to changes made in the generation skipping tax in the mid 80's, and particularly the "predeceased parent exclusion," people whose children have predeceased them are put at a death and gift tax disadvantage if they set up charitable trusts which go to their grandchildren after the period of charitable use. The rate of tax apparently can be as high as almost 80% as compared to a direct gift of their assets to their grandchildren which would bear only a 55% tax. There would appear to be no reason for this difference. The same is apparently true for those who have no lineal descendants surviving them and who might leave their property to grandnieces and grandnephews who are their closest living relatives.

I have been involved with financial affairs for colleges long enough, and have seen enough contribution situations, to know that if persons were faced with a confiscatory tax at these percentages, most would probably not be so generous with our University.

I am also advised that the imposition of this generation skipping tax was aimed at those who were skipping generations of live people, which is not the case in either situation earlier described. These persons are not skipping anyone; they are merely leaving their assets to their closest living relatives. They just happen to be collateral descendants, in the one case, rather than lineal descendants. And the fact that they would choose to let our University enjoy the trust income for awhile, would put them in this penalizing tax situation all by itself, in the other case.

So here we have the anomaly of an unintended tax which would discourage such gifts.

We are very fortunate to have our new gymnasium and library. If the gifts that made these possible were being considered today, they might not have been made.

The tax laws of our country have been designed to encourage charitable donations. This is a policy deeply rooted in our system. For this, we are extremely grateful, to be sure. We could not exist without this encouragement. But in the midst of this lies a happenstance discouragement which needs to be removed. As I stated earlier, I am not a tax expert. However, one does not need to be a tax expert to see that these provisions are working opposite from what they were intended to accomplish--all to our detriment.

We strongly urge the broadening of the "predeceased parent exclusion" to cover trust gifts where consistent with the intent and purpose of the generation skipping tax law and to cover collateral descendants for those who have no children or grandchildren.

Sincerely,

Keith Lovin

Keith Lovin
President

KL:cm

UNIVERSITY
of ARKANSAS

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Subcommittee on Select Revenue Measures
Committee on Ways & Means
Hearings on Miscellaneous Revenue Issues
September 23, 1993

Statement of A. H. Edwards
Vice Chancellor for University Advancement
University of Arkansas
Fayetteville, Arkansas

Mr. Chairman:

I am A. H. "Bud" Edwards and I am currently the Vice Chancellor for University Advancement at the University of Arkansas. I have held this position since August 1989. As a member of the Chancellor's Cabinet, I participate in the overall management of the University. In my role as Vice Chancellor I plan, organize, schedule, coordinate, report, and budget in the areas of alumni programs, creative services, development, public information, and major university events. My objectives include the development and implementation of a communications plan to promote and establish public perceptions of the University of Arkansas as a center of academic excellence and a valuable asset to the State of Arkansas; the planning and implementation of a total development program; the development of alumni programs; and the maintenance and improvement of high-quality University of Arkansas publications.

The University of Arkansas is located in Fayetteville, Arkansas. It is the flagship campus of the University System.

Like most, if not all, public universities, we are challenged constantly to supplement our public financial support with private contributions from friends of the University who are anxious for us to maintain our program at the highest possible level. We have needed and enjoyed the tax policies of this nation which foster charitable giving in these efforts.

However, we have become aware of estate and gift tax issues which need to be re-examined because of some inadvertent effects on our private financial support.

We wish here to express the University of Arkansas' strong support for amending the Generation Skipping Transfer (GST) tax to expand the predeceased parent exclusion (1) to include taxable terminations and distributions from a trust and (2) to cover collateral descendants where the transferor has no lineal descendants.

By making the predeceased parent exclusion inapplicable to anything other than a direct gift to a qualifying beneficiary, the GST tax as presently structured effectively prohibits donations through the use of a charitable lead trust where the predeceased parent exclusion would otherwise apply. No matter how strong the donor's charitable interest, the donor is unlikely to be willing to suffer an additional fifty-five percent tax on the bequest to his descendants.

Charitable lead trusts are a very important source of contributions to the University of Arkansas and charities of all kinds. It makes no sense to discourage their use where there is plainly no attempt at tax avoidance whether the gift is made directly to the beneficiary or after an intervening charitable trust.

We also believe that it is unfair to limit the predeceased parent exclusion to lineal descendants. A donor who happens to be without children and grandchildren should not be treated differently from a donor who has grandchildren. Assessing the GST tax on the bequest of the childless donor to his collateral descendants reduces the estate significantly and discourages charitable giving, as well.

We hope that this amendment can be accomplished.

Sincerely,

Bud

A. H. Edwards
Vice Chancellor for University Advancement

HEARINGS BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

ON

MISCELLANEOUS REVENUE ISSUES

Statement
of
Jack A. Belz
President and CEO of Belz Investment Company, Inc.,
A Real Estate Development Company

June 1993

Mr. Chairman and Members of the Subcommittee:

My name is Jack Belz and I am the President and Chief Executive Officer of a family real estate business in Memphis, Tennessee. Thank you for permitting me to offer this testimony on behalf of Miscellaneous Issue No. 14, a proposal to extend the "in service" date for projects affected by Section 204(a)(1)(E) of the Tax Reform Act of 1986. My testimony also concerns Tax Exempt Bond Issue No. 11, a proposal to extend the date by which certain tax-exempt bonds used to finance such projects can be issued.

This proposal extends the placed-in-service date for certain federally-assisted construction projects in order for the property to benefit from accelerated depreciation transition relief as was originally intended by the Tax Reform Act of 1986. In particular, the proposal extends the placed-in-service date until January 1, 1999, for certain property otherwise qualifying for accelerated depreciation transition relief under the 1986 Act, provided that the ACRS depreciation benefits are deferred until taxable years beginning on or after January 1, 1999. The proposal will also allow for an extension on the issuance of tax-exempt bonds already made available to finance such projects to December 31, 1998; however, no qualifying bonds can be issued prior to October 1, 1998.

This proposed legislation is drafted to benefit all otherwise qualifying projects whose completion has been frustrated by federal funding and regulatory delays. My testimony today will focus upon one particular proposed project, Peabody Place, that will be affected by the proposal to extend the placed-in-service date for certain projects described in Section 204(a) of the Tax Reform Act of 1986. Let me stress that the primary beneficiaries of this proposal are the City of Memphis and its citizens. Peabody Place will be the crown jewel of downtown Memphis and an outstanding example of the positive effects of renewing retail marketing facilities in downtown core areas.

The project that my family and I are personally involved with is Peabody Place, a major urban development of greater than $100 million cost in downtown Memphis, Tennessee which has been in the development process for over ten years. This project will extend over four square blocks in downtown Memphis and provide the only modern shopping facilities therein through a mixed-use project including a significant new retail space, a high rise office tower and a separate new corporate office headquarters building, approximately 250 residential units, and a substantial amount of structured parking spaces.

Peabody Place will create thousands of jobs in downtown Memphis and is essential to the economic well being of downtown Memphis and to our City in general as a regional center. It will draw tens of thousands of people into the core of our city and there will be substantial spin-off benefits for other small businesses (minority and otherwise) located in the downtown area. This project has been a centerpiece of the city's efforts to redevelop the downtown section of Memphis. The well being and continued development of many other projects in our downtown plan are predicated upon the completion of Peabody Place. This proposed placed-in-service date correction will enable us to raise the equity necessary to assist us in financing the initial construction costs and covering the large cash operating losses which we know will be incurred in the early years of operation.

As I stated, the Peabody Place development process is over ten years old at this point. We were far along the road in that effort when the Tax Reform Act of 1986 came along and changed the rules on depreciation of real property. At that time we had legitimately planned our project and expended substantial amounts of money in the effort to bring it to fruition, with these efforts being predicated upon the availability of depreciation under the ACRS system. The 1986 Act contained a transition rule which would permit the benefits of ACRS depreciation to be available for our project. We believe that that extension represented a perfectly legitimate use of transition rules to soften the impact of new tax rules on projects that are already underway in reliance upon the then current system of taxation in effect across the country.

At the time that the 1986 Act was passed, however, a cut-off rule was imposed on the placed-in-service date for all projects as to which transition relief had been made available. We were never informed that such a cut-off date would be included. This transition rule cut-off date (January 1, 1991) effectively precluded the utilization of ACRS benefits by the Peabody Place project. At the time we discovered that cut-off date was included, we knew it would be impossible to complete the project and to have it placed-in-service by the end of 1990 due to circumstances beyond our control. We did not, however, find out about the placed-in-service cut-off in time to get Peabody Place included in the first round of technical corrections to the 1986 Tax Act which we understand had been prepared even before passage of the Bill as it came out of conference. Ever since that time we have taken the position that a technical correction should be made with respect to the Peabody Place Project and we still feel very strongly that this is a proper correction and follows the intent to allow Peabody Place to be completed.

As I mentioned, the reasons that our proposal could not be placed-in-service by his cut-off date were outside our control. Our efforts were predicated upon the availability of Urban Development Action Grant funding from the United States Department of Housing and Urban Development. HUD decided to consider funding the Peabody Place Project in two segments, as opposed to a single grant as we had hoped and anticipated. This delayed the availability of funds under the UDAG program. Furthermore, when funding was requested, the weighing factors assigned to the criteria used to award UDAG grants were unfairly stacked against urban areas such as Memphis. As a result, Peabody Place did not receive even preliminary approval from HUD for its second phase of UDAG funding until September 30, 1988, over 4 1/2 years after the date the original application was submitted. These delays at HUD made it impossible to place Peabody Place in service prior to the cut-off date imposed by the Tax Reform Act of 1986. Obviously, the decisions and delays caused by HUD were entirely out of our control.

We have done everything that was humanly possible to continue the development of Peabody Place. Our family and organization have expended untold hours of time; we have negotiated with major retail stores; we have made arrangements and entered into contracts with investment banking firms for the issuance of bonds, we have negotiated construction and bridge financing with various financial institutions, and we have met repeatedly with officials from the City of Memphis and HUD regarding the project. Our blood, sweat and tears have seen this project through to this point. All of this effort, as well as very large sums of money, have been invested on the expectation that the tax treatment promised in the 1986 Tax Act would be available. This project, as I have said before, is vital to the economy of Memphis, Tennessee. I respectfully request that this Subcommittee and the full Committee on Ways and Means effectuate the intent of Congress in enacting the Tax Reform Act of 1986 and assist Peabody Place in becoming a reality by extending the applicable placed-in-service and bond issuance deadlines.

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WRITTEN SUBMISSION
OF THE
INVESTMENT COMPANY INSTITUTE
ON MISCELLANEOUS REVENUE ISSUES PENDING
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS & MEANS
U.S. HOUSE OF REPRESENTATIVES

July 9, 1993

The Investment Company Institute ("the Institute")* submits for the Committee's consideration the following comments relating to (1) a modification of section 623 of H.R. 13, the Tax Simplification Act of 1993, so as to permit the tax-free conversion of a bank common trust fund to one or more regulated investment companies ("RICs"), (2) proposed modifications of section 622 of H.R. 13, concerning the reporting of cost basis information to mutual fund shareholders, and (3) a modification of section 221 of H.R. 13, so as to provide simplified nondiscrimination rules for salary reduction simplified employee plans ("SEPs").

I. Tax-Free Conversion of Bank Common Trust Fund

A. Background

A RIC is a pooled investment vehicle that provides moderate-income investors with the benefits of asset diversification and professional management. A bank common trust fund is a pooled investment vehicle which a bank may establish for certain money that it holds in its capacity as a trustee, executor, administrator, guardian or custodian.

RICs are afforded conduit tax treatment pursuant to Subchapter M of the Internal Revenue Code. Thus, the tax treatment of the RIC investor is comparable to that of the direct investor in securities. Income received by the RIC and distributed currently to RIC investors is taxed only once -- at the RIC investor level.

Pursuant to section 584 of the Internal Revenue Code, bank common trust funds are afforded conduit tax treatment under which the common trust fund is not subject to tax. Instead, each participant in a common trust fund includes in income his or her proportionate share of the common trust fund's income, whether or not the income is distributed. In addition, a withdrawal from a bank common trust fund is treated generally by Code section 584(e) as a sale of an interest by the participant. Regulations under section 584 currently permit a common trust fund to divide into two or more new common trust funds, without regard to which of the original fund's assets are transferred to each new fund, so long as each participant has the same proportionate beneficial interest in each of the new common trust funds as he or she had in the original.

B. Section 623 of H.R. 13

Section 623 of H.R. 13, the Tax Simplification Act of 1993, would amend the rules of Code section 584 to generally permit a bank common trust fund to transfer its assets on a tax-free basis to a single RIC. The Technical Explanation to the provision states that the tax consequences of such a transfer are unclear under present law and indicates that, for simplification reasons, such transfers should be permitted on a tax-free basis.

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* The Investment Company Institute is the national association of the American investment company industry. Its membership includes 4,116 open-end investment companies ("mutual funds"), 336 closed-end investment companies and 13 sponsors of unit investment trusts. Its mutual fund members have assets of about $1.665 trillion, accounting for approximately 95 percent of total industry assets, and have about 38 million individual shareholders.

C. Proposal

The proposed change would permit a bank common trust fund to transfer on a tax-free basis substantially all of its assets to one or more RICs pursuant to a single plan.

D. The Institute's Position

The Institute supports section 623 with the proposed change. Since current law would permit the tax-free split-up of a common trust fund and H.R. 13 would permit the tax-free conversion of a common trust fund to a RIC, there would appear to be no policy justification for prohibiting a common trust fund from accomplishing each of these objectives in one step. Thus, the conversion of a single common trust fund into more than one RIC should be permitted, so long as each participant in the common trust fund has the same proportionate interest in each RIC into which the trust fund converts that he or she held in the original common trust fund.

II. Shareholder Basis Reporting

A. Background

The Revenue Act of 1992 (H.R. 11), which was vetoed in November 1992, included a provision to require mutual funds and other brokers to provide mutual fund shareholders with cost basis information. Specifically, the cost basis would have been computed using the "single-category average cost" method for all shares held in a mutual fund account opened after 1994.

Under certain circumstances, this provision of H.R. 11 would have required funds and other brokers to amend cost basis statements mailed to shareholders because of transactions occurring in the year following the year of the redemption. The sending of amended statements could have confused shareholders, especially if they had already filed their tax returns prior to receipt of the amended statements. These amended returns would also have involved significant administrative costs for funds, brokers and the Internal Revenue Service, which could have been required to process significant numbers of amended returns.

Because of these concerns, Chairman Rostenkowski's proposed Tax Simplification Act of 1993 (H.R. 13) seeks to reduce the problem of amended cost basis statements by making two changes to the rules for computing cost basis. The Institute supports the Chairman's efforts and urges certain modifications to further reduce the volume of amended cost basis statements and simplify the administration of the basis reporting requirement.

B. Wash Sale Rule

1. Volume of Amended Reports

A significant number of amended cost basis reports would be generated if the wash sale rule of Code section 1091 applied to all situations in which the sale or exchange at a loss occurred in December and the acquisition occurred within 30 days in January (a "December/January wash sale"). This could be a relatively common occurrence if a mutual fund shareholder redeemed shares in December and participated in a dividend reinvestment program which automatically purchased shares in January. Even if the shareholder were not in such an automatic purchase program, a redemption of shares in December followed by a purchase of shares in January might result in a wash sale.

2. Cost Basis Reporting and H.R. 13

For those December/January wash sales triggered by purchases of relatively small amounts, such as through the reinvestment of dividends, the amount of the loss disallowed by Code section 1091 on December/January wash sales would generally be small. The costs to shareholders of funds preparing amended 1099s, the costs to shareholders of filing amended tax returns and the costs to the IRS of processing these amended 1099s and 1040s would often be unjustified by the small amount of additional taxes resulting from any disallowed loss. Thus, while the amount of the disallowed loss would in most cases be small, the additional costs and confusion caused by a requirement that funds send amended cost basis reports in February would be significant.

H.R. 13 would address this problem by modifying Code section 1091 to disregard any shares purchased pursuant to a dividend reinvestment plan after January 15 of the year following the year of redemption from a "covered account" on which basis reporting is required, provided that the shareholder entered the dividend reinvestment plan when the account was opened or, if later, at least 6 months before the date of redemption.

3. Institute Proposal

The Institute recommends that Code section 1091 be modified to disregard any shares purchased in January of the year following the year in which shares were redeemed at a loss from a "covered account" on which basis reporting is required under proposed new Code section 6045(f) and either (a) the shares were purchased pursuant to a dividend reinvestment plan or (b) the amount of the loss that would be disallowed by Code section 1091 is $25 or less.

a. The Reinvested Dividend Exception Should Apply to All Dividends Reinvested During the Month of January

H.R. 13 would limit the relief for December/January wash sales to dividends reinvested after January 15. This limitation to the wash sale relief afforded by H.R. 13 is too restrictive. Instead, the dividend reinvest exception should be extended to cover shares purchased at any time in January pursuant to a dividend reinvestment plan.

Virtually all wash sales which relate to automatic dividend reinvestments in the first 15 days of January would require amended cost statements. There would simply not be adequate time to apply the wash sale rule in these cases, determine any cost basis modifications, convey the information to the appropriate reporting entities and then print and mail the 1099s by January 31.

As a practical matter, with about 38 million individual shareholders owning over 70 million accounts in over 4,000 funds, year-end tax information that cannot be generated by early in January has very little chance of being reflected on 1099s mailed by the end of January. For example, with respect to 1992 tax information returns, brokers required funds to provide all year-end tax information for inclusion on 1099s mailed in January no later than January 8, 1993. Similar pressures to get tax information computed very early in January apply to those funds which provide year-end tax information directly to their shareholders. The sheer volume of work that must be done between December 31 and January 31 cannot be compressed into a significantly shorter time frame. Adding shareholder basis reporting to the year-end tax reporting tasks currently required would only increase the pressure to complete these year-end computations and thus decrease the likelihood that any information unavailable until after December 31 will be reflected on January 1099s.

H.R. 13 already provides for automatic dividend reinvestments in the second half of January. If shares purchased with dividends reinvested after January 15 do not create tax policy concerns, why should not shares purchased with reinvested dividends before that date receive similar treatment? It is unlikely that funds will change the date in January on which they pay dividends simply to eliminate the possibility of wash sales attributable to reinvested dividends in that month.

Funds have strong business reasons for paying dividends during the first half of January. One such consideration is the effort by fund complexes to spread workloads evenly throughout a year and within each month. In the case of income funds, this effort typically results in a spreading of dividend payment dates throughout the month. Thus, for example, fund complexes with 15 or more income funds paying monthly dividends may adopt a schedule whereby three or four funds pay dividends each week. Moreover, because income funds paying monthly dividends are typically marketed as investment products that produce an income stream, i.e., dividends paid at regular intervals, such funds would be reluctant to change the dates solely of their January dividends to the second half of the month. Shareholders often rely on these regular dividends as a source of cash to meet recurring monthly expenses.

The Institute urges that all shares acquired in January pursuant to a dividend reinvestment program be exempted from the wash sale rule because wash sales generated by virtue of an automatic, involuntary purchase through a dividend reinvestment plan should not be viewed as the type of abusive transaction that Code section 1091 was designed to deter. Moreover, any shareholder electing to use the average cost basis method has selected a method of computing gain or loss that is less advantageous than specific identification and is, therefore, unlikely to be reinvesting dividends simply to benefit from a loss otherwise subject to the wash sale rule. A taxpayer interested in generating usable tax losses can almost surely generate bigger losses with less trouble simply by using the specific identification method and selling only high cost assets.

For this reason, we also question the need for a rule that excepts only those wash sales of shareholders who elected to participate in the dividend reinvestment program at the time the account was opened or, if later, at least six months before the date of the redemption. The complexity and burden required to comply with this limitation is unnecessary, since shareholders using the average cost method cannot achieve a better tax result through the exception for reinvested dividends than can be achieved by computing gain or loss under the specific identification method. If, however, the Congress remains concerned that the dividend reinvest exception might be utilized in an inappropriate manner, the law could state that if the Secretary determines that shareholders who are not bona-fide participants in dividend reinvestment programs are reinvesting only dividends paid in January, then the Secretary could limit the exception from the wash sale rule to shareholders who elected to participate in the dividend reinvestment program at the time the account was opened or, if later, at least six months before the date of redemption.

b. Certain De Minimis Transactions Should Also Be Exempt

In addition to excepting wash sales resulting from dividends reinvested in January, a dollar de minimis exception should also be provided. The dollar amount of some transactions is so small that the potential benefit of applying the wash sale rule is outweighed by the costs and other burdens to the shareholder, the IRS and the fund industry of amended 1099s. It hardly makes sense to send an amended 1099 to reflect a redemption in December and a purchase in January if the amount of the disallowed loss is quite small. For that reason, the Institute proposes that the wash sale rule not apply where the amount of the disallowed loss attributed to a December/January transaction is $25 or less. The effect of this $25 de minimis rule would be to limit the maximum amount by which a shareholder's tax liability could be reduced through use of the December loss to less than $10. Moreover, it must be remembered that this benefit is only one of timing, since the amount of any loss disallowed under the wash sale rule is included in the basis of the acquired shares.

C. Sales Load Basis Deferral

1. Present Law

In general, charges paid to purchase investment property are included in the cost basis of that property. The sales load basis deferral rule of Code section 852(f) provides an exception to the general rule, however, where a shareholder (1) incurs a load charge in acquiring shares in one fund ("Fund A"), (2) disposes of such Fund A shares within 90 days after they are acquired and (3) on any date thereafter acquires shares in Fund A or in another fund ("Fund B") for which the otherwise applicable load is reduced or waived. In this situation, the load paid on the Fund A shares will be included in the basis of the Fund B shares, rather than the Fund A shares, to the extent that the load paid on the Fund B shares has been reduced or waived. The effect of Code section 852(f) is to prevent an investor who desires to purchase shares in Fund B from first purchasing shares in Fund A and then promptly exchanging his investment into Fund B and creating a tax loss on the sale of the Fund A shares equal to the amount of the sales load paid on those shares.

2. Cost Basis Reporting and H.R. 13

Application of the sales load basis deferral rule to mutual fund cost basis reporting with no modification could, in certain instances, create significant tax administration difficulties by requiring funds to send amended cost basis reports months or years after the original reports were sent and shareholder tax returns were filed. These instances occur when a shareholder purchases and redeems Fund A shares within 90 days, invests the proceeds in a no-load fund, such as a money market fund, and has not, by the end of the calendar year in which the redemption occurs, acquired shares in another fund at a reduced or waived load. In this event, the fund reports the load in the basis of the Fund A shares. But if the shareholder subsequently acquires shares in Fund B and the otherwise applicable sales load on the Fund B shares is reduced or waived, the sales load basis deferral rule retroactively reduces the basis of the Fund A shares by the amount of the reduced or waived load and includes that amount in the basis of the Fund B shares.

H.R. 13 would deal with this problem by modifying Code section 852(f) to provide that if (1) shares in Fund A are purchased and redeemed within 90 days and (2) shares in that fund or another fund ("Fund B") are purchased at a reduced or waived load after January 15 of the year following the year of the redemption, the amount of the reduced or waived load (1) would not be subtracted from the basis of the redeemed shares, (2) would be included in the shareholder's gross income as short-term capital gain in the year in which shares were subsequently purchased at a reduced or waived load and (3) would be included in the basis of the subsequently acquired shares.

3. The Institute Proposal

The Institute recommends that H.R. 13 be modified to provide that the sales load basis deferral rule not apply where the shareholder (1) computes basis using the average cost method and (2) acquires fund shares at a reduced or waived load after January 31 of the year following the year of the redemption.

The current provision in H.R. 13 would likely be a major source of shareholder confusion to the vast bulk of shareholders who would be affected by the rule and who had not manipulated their purchases and redemptions simply to create a loss for tax purposes. For example, under H.R. 13, the purchase of shares in Fund B at either no load or a reduced load would sometimes reduce the basis of the Fund A shares and sometimes generate short-term capital gain. Shareholders would need to be informed that different treatment would arise depending on whether the Fund B shares were acquired before or after January 15 of the year following the year of the redemption. Additional shareholder confusion would arise from the sending of a 1099 showing short-term capital gain for the year in which the Fund B shares were acquired. This confusion would be particularly difficult to overcome if the short-term capital gain is attributable to a load paid several years earlier. Finally, shareholders might have a difficult time understanding why a 1099 showing short-term capital gain income has been sent when no cash has been received from the fund and no shares have been redeemed.

Mechanical reporting issues would arise as well. For example, would the 1099 showing a short-term capital gain be sent by Fund A, which the shareholder initially purchased at a load, or Fund B, which the shareholder acquired at a reduced or waived load? If the shareholder had redeemed all of his Fund A shares, it would seem odd for Fund A to send a 1099 months or years after the investment in Fund A was liquidated. However, it may seem equally odd to receive a 1099 from Fund B which has not distributed the reported income and from which no shares have been redeemed.

Similar questions arise as to whether the short-term capital gain would be reported on a 1099-DIV, which does not currently contain a box for short-term capital gain distributions, or on a new mutual fund 1099-B, used to show redemption proceeds and basis information for covered accounts under proposed new Code section 6045(f). Under the bill, the proposed amendments to Code section 852(f) would apply in 1995 with respect to all mutual fund accounts and not just to those "covered accounts" opened on or after January 1, 1995.

The recommended alternative, on the other hand, would continue to prevent taxpayers who desire to purchase Fund B shares from generating a tax loss by instead purchasing and promptly redeeming Fund A shares before the Fund B shares are purchased. A shareholder who wishes to purchase Fund B shares would have to first purchase and redeem Fund A shares within 90 days and retain the proceeds in cash or in a money market fund for at least one month, i.e., until February of the year following the purchase and redemption of the Fund A shares, to escape application of the rule. This strategy seems unlikely to occur since it would put the investor at the risk of an often volatile market for at least one month.

III. Nondiscrimination Safe Harbors for Salary Reduction SEPs

A. Background

Mutual funds traditionally have served as vehicles through which investors channel their investment dollars into the nation's economy through a diversified, professionally managed pool of securities. Increasingly, mutual funds are also serving as the investment medium for retirement income programs, including both qualified defined contribution and defined benefit plans, individual retirement arrangements ("IRAs") and simplified employee pensions ("SEPs"). In addition, many mutual fund organizations provide ancillary services to retirement plans, such as recordkeeping and sponsorship of prototype retirement plans.

The Institute has long supported two related retirement policy goals: increased retirement plan coverage, particularly for small employers, and simplification of the rules governing retirement plans. Indeed, the Institute believes that pension simplification is a key component of encouraging employers to provide retirement programs for their employees. Thus, the Institute historically has been a strong proponent of the use of the simplified employee pension ("SEP") and the salary reduction SEP as the vehicles through which both goals can be accomplished. Because of their relative simplicity and ease of administration, the SEP and the salary reduction SEP are particularly appropriate for small employers, who may otherwise be deterred by the complexity and expense involved in qualified plan adoption and administration.

B. Provisions Of H.R. 13 Relating to Salary Reduction SEPs

The Institute supports the pension simplification provisions contained in H.R. 13. In particular, the Institute believes that the expanded availability and simplification of the salary reduction SEP could be a further step toward the goal of increased retirement plan coverage.

However, the provisions concerning salary reduction SEPs are lacking in one important respect: H.R. 13 would retain the current nondiscrimination rules that require sponsors of SEPs to periodically compare the average deferral percentage ("ADP") of highly compensated employees and that of non-highly compensated employees, and adjust the contributions if necessary. The purpose of this testing is to ensure that highly compensated employees will not receive a disproportionately greater share of the plan's benefits than non-highly compensated employees, but the necessity of performing these cumbersome tests may deter small employers from adopting these plans.

Such testing is also currently required under qualified 401(k) plans, but H.R. 13 would permit qualified 401(k) plans to satisfy the nondiscrimination rules through the use of safe harbors requiring either mandatory employer contributions or employer matching contributions. These alternatives would allow the employer to know in advance that the plan met the nondiscrimination rules and avoid the necessity of cumbersome periodic testing.

However, H.R. 13 does not include the nondiscrimination safe harbors for salary reduction SEPs. As a result, under H.R. 13, the testing rules for the salary reduction SEP -- the simplified 401(k) plan for small employers -- would be *more* complex than the rules governing a qualified 401(k) plan.

C. The Nondiscrimination Safe Harbors of H.R. 13 Should Also Be Made Available to Salary Reduction SEPs

As proposed, the pension simplification provisions of H.R. 13 provide no further encouragement for the use of salary reduction SEPs by the very employers that could otherwise benefit from them. Simplified nondiscrimination rules for salary reduction SEPs will help move toward the goal of increased coverage. With this modification, financial institutions, such as mutual funds, will be strongly motivated to actively advertise and market salary reduction SEPs.

The Institute therefore urges the Committee to amend H.R. 13 to apply the nondiscrimination safe harbors to both 401(k) plans and salary reduction SEPs.

The Honorable Barbara B. Kennelly
Testimony for the Record
Select Revenue Subcommittee
Committee on Ways and Means
Miscellaneous Tax Issues Hearing
June 14, 1993

Mr. Chairman, I would like this opportunity to offer my support for a number of issues before the Committee and Subcommittee.

First and foremost, I would like to reiterate my strong support for a provision which was reported by this Committee last year, passed the House on the suspension calendar, included in H.R. 11 and ultimately vetoed by the President. This provision would simply exclude from gross income payments made to police and fire officials as a result of heart disease or hypertension incurred in the course of employment and misclassified for federal tax purposes as a result of state errors.

This statutory change is necessary because an error in state law in several states, including Connecticut, caused the IRS to deem the benefits taxable. These benefits were intended to be treated as workmen's compensation. In Connecticut, at least, the state law has been corrected so that while there is a presumption that such conditions are the result of hazardous work, the state or municipality involved could require medical proof. Therefore, this provision would exempt from income those payments received by these individuals as a result of faulty state law but only for the past three years--1989, 1990 and 1991.

This provision is vital to those public servants who served their communities and now find themselves disabled. These individuals have made a good faith effort to comply with what they thought was the law. The states were in error and where that error has been rectified these individuals on disability should not required to pay 3 years back taxes plus interest and penalties.

I have introduced this provision (H.R. 225) in the 103rd Congress. It enjoys broad support in the Connecticut delegation and I would hope it could be enacted expeditiously.

I would also like to express my support for a tax-exempt bond provision. This provision is listed as #15 on page 7 of the June 2, 1993 Subcommittee Press Release. This is a Connecticut specific item which would exempt from the arbitrage rebate rules certain bond issues closed prior to December 1989 which would have met the six month rebate service exception but for the fact they included a debt service reserve. The Tax Reform Act of 1986 provided an exception from rebate for a bond issue if all its proceeds were expended within six months. The Act did not, however, address those cases in which all proceeds, except for a debt service reserve, were spent within 6 months. The Budget Reconciliation Act of 1989 modified the rebate exception and applied it to the expendable portion of bond issues with debt service reserves for bonds issued after December 31, 1989.

Connecticut's special tax obligation bond issues have been sized, timed and structured to fund requisite projects on a cash as needed basis. Therefore, the state finds itself with a very small number of bond issues which closed between September 1986 and December 1989 and that were fully expended within six months, except for a debt service reserve. It is fairly uncommon for bonds of this nature to be expended so quickly. These bond issues were designed with both the spirit and intent of the Tax Reform Act of 1986. Therefore, I would hope that the Subcommittee and full Committee would look favorably on my proposal to extend the six-month exception from rebate to certain bonds the proceeds of which included a debt service reserve and which were issued after the Tax Reform Act of 1986 and before the Budget Reconciliation Act of 1989.

Finally, I would also like to express my support for the cost recovery provision listed as #2 on page 3 of the Subcommittee Press Release dated June 2, 1993 and as clarified by the Subcommittee Press Released dated June 11, 1993.

This proposal would provide a new cost recovery period for helicopters used in timber management and harvesting. Said property would be depreciated over a 3 year period for regular tax purposes and over a 4 year period for alternative minimum tax purposes. As Connecticut and the nation struggle to adapt to a post-Cold War World economy, it is important that we encourage the conversion of defense-related skills and investments to alternative applications in the commercial sector. This provision would foster industry conversion and retain critical manufacturing capability and maintain employment. I would hope that the Subcommittee and full Committee would also look favorably on this proposal.

Thank you, Mr. Chairman.

National Association for the Self-Employed
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SUBMISSION FOR THE RECORD

June 29, 1993

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenues
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr Chairman:

The National Association for the Self-Employed (NASE) is pleased to submit this letter for consideration by the Subcommittee on Select Revenue Measures regarding the June 1993 hearings on miscellaneous revenue measures. I respectfully request that the NASE's letter be inserted as part of the record for these very important hearings. The NASE represents over 320,000 small business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, primarily in the consulting services and retail fields. The letter provides comments on the issues of direct expensing and independent contractors.

Direct Expensing

In general, if a small business taxpayer purchases equipment or other property for use in the active conduct of his business, the taxpayer may elect (in lieu of depreciation) to take a deduction representing the cost of the property for the year it was placed in service. This Tax Code provision is popularly called "direct expensing." Under current law, a small business taxpayer may directly expense up to $10,000 of equipment purchases per year. The NASE considers this Tax Code provision to be very important to small business. This Tax Code measure is pro-growth and should be considered a critical component of any plan to spur the U.S. economy. In turn, the measure is an important economic tool designed to create jobs for the American work force.

The 1993 House budget reconciliation bill (H.R. 2264) would increase the maximum direct expensing amount for a small business taxpayer from $10,000 to $25,0000. In adopting this measure, the House Ways and Means Committee stated the panel's proposal would "provide an incentive for small businesses to increase their investment in capital assets, thus promoting economic growth and increasing demand for productive assets." The NASE strongly supports the direct expensing measure contained in the House version of H.R. 2264.

Section 280F of the Tax Code effectively limits a taxpayer's direct expensing deduction on the purchase of an automobile or light truck to $2,560 for the year the vehicle is placed in service. Current law indexes this $2,560 amount for inflation. The Subcommittee is considering a proposal to fully extend direct expensing to the purchase of an automobile or light truck. It is the NASE's understanding that this initiative might be accomplished by amending the provisions under Section 280F. The NASE believes this proposal could be a very meaningful measure for small business based on the fact cars and trucks are often a small business's largest and most important asset. We strongly recommend that the House Ways and Means Committee give serious consideration to this proposal.

Independent Contractors

The current state of affairs is a morass for persons claiming independent contractor status under the tax law and regulations. Internal Revenue Service Agents are vigorously auditing companies utilizing workers as independent contractors. These audits place a significant burden on these companies should the IRS reclassify these workers as employees. The compliance costs and the potential payroll taxes due as a result of the audit can often be significant enough to force the company subject to the audit out-of-business.

The NASE is very concerned about the impact that the current IRS audit process is having on the companies utilizing the skills of independent contractors. We are also very concerned about the impact of this audit process on the independent contractor himself. The NASE believes the current state of affairs -- that is, the high intensity of IRS audits of independent contractor status -- is having a pronounced, but negative impact on the spirit of entrepreneurship in the United States.

Page 2
Hon. Charles B. Rangel
June 29, 1993

By enabling companies to hire workers as independent contractors as opposed to requiring them to treat such persons as employees, a company is provided with flexibility in making its management decisions -- something that is very important in today's extremely competitive economy. Such a firm is able to determine for itself what it considers is the most productive way to operate the business without the commitment of scarce financial resources to the hiring of a person full time. The person working as an independent contractor also benefits. He or she benefits from the preservation of the entrepreneurial spirit and the dream of owning a business.

The NASE does not view the independent contractor issue as a situation where companies or self-employed persons are intentionally attempting to evade the law. Instead, we believe the problem with the issue revolves around the vagaries of the current tax law and regulations. Under current law, a worker is classified as an employee or an independent contractor based on an analysis of 20 common law factors. This 20 factor test is grounded in medieval-age tort law concepts involving master-servant relationships. The underlying premise of the 20 factor test is based on the degree to which a company controls the work of the service provider.

To the extent a business has misclassified a worker as an independent contractor, the misclassification is likely to have been inadvertent and a result largely due to the fact the 20 factor test is vague and difficult to interpret. The tax law should not be based on vague medieval tort law concepts. In contrast, the law should be simple to administer from the IRS perspective and it should generate no more revenue for the Treasury beyond what is considered fair and reasonable. From the business person's perspective, the law should not impose an unfair tax burden or excessive compliance burdens.

In representing over 320,000 self-employed persons, the NASE urges the House Ways and Means Committee to take steps to foster and promote independent contractor status. Vigorous promotion of the independent contractor status is necessary for the preservation of the nation's entrepreneurial base. This could be accomplished by drafting legislation to clarify the 20 factor test and the treatment of independent contractors under the tax law. In this regard, the NASE is pleased the Subcommittee is considering legislation which would permit distributors of bakery products to be treated as independent contractors, instead of being treated as statutory employees. We support the spirit of this kind of initiative, particularly if the proposal signals the Subcommittee's interest in reviewing the full range of problems associated with IRS audits in the independent contractor area and their impact on the broad array of industries doing business in the United States.

The NASE appreciates the opportunity to provide the Subcommittee with the organization's views on the issues of direct expensing and independent contractors. We look forward to working with the Subcommittee on these and other issues of importance to the nation's small business community.

Sincerely yours,

Bennie L. Thayer
Chairman/CEO

Any comments or questions may be directed to:

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1101 15th Street N.W., Suite 400
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(202) 466-2100

STATEMENT OF
DAVID N. DINKINS
MAYOR OF THE CITY OF NEW YORK
CONCERNING
MISCELLANEOUS ITEMS SCHEDULED FOR HEARING BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS

JULY 20, 1993

Thank you, Mr. Chairman, for this opportunity to present to you the position of the City of New York on several of the items scheduled for hearing before your Committee. In the interest of brevity, I will comment at length only on certain of the items, where the experience of the City of New York might be of particular help in informing your judgment.

Of the more than one hundred items set forth, I wish to comment on six. For consistent reference, I will refer to the items by the headings and reference numbers contained in the Committee's June 2, 1993 announcement.

Before moving to the items scheduled for hearing, I must comment on two issues not mentioned in the press releases, but which are important to the City of New York.

Income from canceled student loans. The first of those items concerns the tax treatment of loans canceled under the 1992 Higher Education Act Amendment. Those amendments include a loan forgiveness for all borrowers who were unable to complete their program because of a school closing or who the school had falsely certified as eligible for a loan. The forgiveness applies prospectively and retroactively to borrowers who received loans on or after January 1, 1986.

This 1992 amendment, proposed by New York City and several low-income student advocacy organizations, was intended to benefit thousands of low-income students who had been adversely affected by proprietary trade school abuses of the federal student aid program. Unfortunately, under general tax principles this Congressional relief means that these low-income students will be taxed on the value of the loan. The benefit Congress meant to confer on these students - relief from the obligation incurred as a result of proprietary trade school abuses - will partially be negated by a tax on the phantom income from the forgiveness of the loan, with the potential for penalties and interest as well. These individuals may also be rendered ineligible for the Earned Income Tax Credit because of this phantom income.

The City of New York believes that this result is extremely unfair. These individuals received no benefit from these loans and the legislative cancellation of the loan should not result in taxable income to the students.

Use of HOME and the 70 percent present value Low Income Housing Tax Credit. The City supports, with a modification, the provision in the House Fiscal 1994 reconciliation bill to allow the 70 percent present value credit with HOME funds with certain deeper targeting. The targeting formula, however, does not parallel the existing LIHC formulas. The modification would make the amendment parallel the existing targeting formulas.

The House provision states that to qualify for the 70 percent present value credit, the project must have 40% of the units occupied by tenants with incomes less than 50% of the area median income. By itself, that deep targeting in New York City, with its high housing costs, is not feasible. Targeting that deep results in lower rents and lower project income. New York has high operating costs and the projects would not be financially stable with such reduced income. Even with deep subsidies provided by the City, such projects would not even be able to meet their operating and maintenance costs.

The deeper targeting was arrived at by substituting 50% of area median income for 60% of area median income in the Low Income Housing Tax Credit targeting formula. In general, that results in the formula above - 40% of the units at 50% of median income. In recognition of the City's high housing costs, however, the targeting in New York City for 60% of area median income is 25% of the units, not 40% (see, secs. 42(g)(4), 142(d)(6) of IRC). If the deeper targeting for the HOME assisted projects is 25% of the units at 50% of median, the projects would be feasible in the City.

The following chart sets out the relevant targeting:

Present law general rule	House reconciliation provision
40% of units at 60% of median income	40% of units at 50% of median income
Present law New York City	House reconciliation provision
25% of units at 60% of median income	no provision

The statutory language adopted by the Ways and Means Committee will not apply the special New York City targeting formula to the HOME provision because, we understand, that special provision was not discussed at the markup. The City urges the Conference Committee to amend the House provision to allow the 70 percent present value credit for projects in New York City using HOME funds that have 25% of the units at 50% of median income.

Thank you for allowing me those two important digressions. Let me now turn to the issues announced for the hearing.

HOUSING

One of the most successful housing programs the federal government has ever undertaken is the Low Income Housing Credit program (LIHC). Although Congress voted twice last year to make the program permanent, both times President Bush vetoed the legislation. New York City has successfully used the credit in conjunction with direct City loans to expand housing opportunities for its poorest citizens. To date, tax credits have been used to create over 5300 low-income units in the City. Over 1350 additional units are in construction. The principal program designed to utilize the tax credit in New York City is the Local Initiatives Support Corporation (LISC)/Enterprise Foundation Program, named for its prime nonprofit sponsors. In this program, the nonprofit organizations raise capital by offering corporate investors tax credits in exchange for equity participation in low-income housing development. These funds are then used in conjunction with direct City loans in order to finance the renovation of City-owned vacant buildings.

Item 3: Changes to the Deep Rent Skewing Rules. This proposal was included in the Senate reconciliation bill, although because it was combined with a separate proposal, certain inappropriate requirements appear to have been added to it. The discussion of this item concludes with a recommendation concerning the Senate language.

The original enactment of the LIHC included a set of provisions referred to as the Deep Rent Skewing Rules. These rules were designed to encourage the development of mixed income housing in places where high housing costs make the development of any housing difficult. The principle behind the Deep Rent Skewing Rules is that if a project elects to maintain a particular ratio of market rate rents to low-income rents and deeper targeting than otherwise is required, then the cash flow necessary to give the project financial stability will be protected. The rules themselves are very complex and it is not necessary to go into them here because the proposed amendment would affect only one aspect of the rules - the ratio between market rate and low-income rents.

As originally enacted, the Low Income Housing Tax Credit provision required that the market rents be three times the low-income rents in order to qualify for the Deep Rent Skewing Rules. In 1989, it was determined that the three-to-one ratio was too great and the Rules were amended to reduce the ratio to two-to-one for credits allocated after 1989. Unfortunately, the 1989 amendment made no provision for those projects that had elected deep-rent skewing under the three-to-one standard between 1987 and 1990, nor did it make provision for projects that received allocations between 1987 and 1989 that could not meet the three-to-one standard but could meet the two-to-one standard.

The City urges the Congress to adopt a provision to allow projects that were allocated credits in between 1987 and 1989 180 days to make an irrevocable election to use the two-to-one standard. Projects should be allowed this election regardless of whether the project originally elected to use the deep rent skewing rules under the three-to-one standard.

This amendment is appropriate for those projects that elected to use deep rent skewing under the three-to-one standard because the reduced rents available in the present real estate market force them into choices that jeopardize the financial security of the projects and because the Congress has already determined that the three-to-one ratio is too high. In order to maintain the three-to-one ratio, projects are forced to either keep the market rate units at three times the low-income units - and are likely to have them remain vacant because those rents are now above market - or reduce the low-income rents so that the market rents can be reduced and the three-to-one ratio maintained, thus jeopardizing the financial stability of the project.

This amendment is also appropriate for those projects that did not elect to use deep rent skewing because they could not meet the three-to-one standard, but which can meet the two-to-one standard, because those projects also need the protection afforded to mixed-income projects by these rules.

Although it is theoretically possible that a project could respond to this amendment by raising the low-income rents, rather than reducing the market rate rents, that will not happen. To the best of our knowledge, Deep Rent Skewing projects are located only in New York City. Under the rent stabilization laws of the City of New York, the low-income rents cannot be raised except to keep pace with approved stabilization increases intended to offset increased owner costs. Further, many, if not all, of the low-income tenants receive rental assistance under the federal Section 8 program, and their rents are fixed under that program. Further, the LIHC itself restricts the rent that can be charged. Nevertheless, recognizing that further assurances may be desirable from the Committee's point of view, the City would support a provision that would state that no rent may be increased as a result of this provision.

As mentioned above, the Senate reconciliation bill already includes a provision intended to allow projects to elect the two-to-one standard. As written, however, the provision would not actually provide the intended benefit. The provision combines that election with an election to retroactively apply another 1989 amendment concerning the maximum rent that may be charged. As a result, the Senate provision can be read to require that a project must elect both provisions, and cannot elect just one. Further, the Senate provision would apply only to those tenants that first occupy the unit after the election is made. Although that requirement may make sense for the amendment concerning maximum rents, it makes no sense concerning the Deep Rent Skewing Rules. The Deep Rent Skewing rules apply on a project-wide basis and the project would have to meet all of the requirements on the day the election takes effect. The requirement in the Senate bill would, in effect, require the project to have all new tenants on that day in order to get the benefit of the provision - in other words to evict all the existing tenants. That is not only extremely undesirable, but legally impossible in New York City.

Item 5: Use of 70 percent present value credit with tax-exempt bonds. The City urges that Congress permit the 70 percent present value credit to be used in conjunction with private activity tax-exempt bonds. Neither bond financing nor the LIHC alone are enough to stimulate the production of low- or moderate-income housing in the City. Under present law, tax exempt bonds can be used only with the 30 percent present value credit, and even that incentive is not enough. In order to make the programs more effective, the 70 percent present value credit should be available with tax exempt financing. As under present law, state and local housing credit allocation agencies would have to demonstrate that no more credit was provided than that which is necessary to make a project feasible.

Item 6: Designation of qualified census tracts and difficult to develop areas. The City urges that the procedure be modified for determining which census tracts qualify for the increase as high cost areas. Section 42(d)(5)(C) provides for a 30 percent increase in basis for projects located in high cost areas. There are two types of high cost areas: (1) census tracts with a median income of 60 percent of the area median income ("qualified census tracts"), and (2) "difficult to develop" areas. No more than 20 percent of the population of a metropolitan statistical area can be in qualified census tracts. Because of the population limitation on census tracts, some tracts will not qualify for the benefit although they meet the poverty rate eligibility criteria. Similarly, only 20 percent of the nation may qualify as a "difficult to develop" area.

The Department of Housing and Urban Development (HUD) designates which census tracts, among all those eligible, will qualify for the benefit without consulting state or local authorities or coordinating the designation with the housing plans of the state or local jurisdiction. For instance, in New York City, so many census tracts are poor enough to qualify that not all can, because of the 20 percent of population limit. HUD chose which census tracts would qualify without regard to the state or local housing plans. As a result, low-income housing projects located in eligible neighborhoods, especially in Manhattan, will not get the benefit of the provision. At the same time, HUD designated other neighborhoods as qualified although there are no plans for any projects in those neighborhoods.

The City urges that the population limitation on qualified census tracts be eliminated and that any census tract with a median income 60 percent or less of the area median income be eligible for the increased credit.

TAX-EXEMPT BONDS

Item 4: New two, three, and four family houses eligible for Mortgage Revenue Bonds. Expanding opportunities for homeownership has traditionally been an important component of the City's overall housing program. In fact, since 1987 when the City launched its first major capital spending for housing, more than $140 million in City funds have been committed in order to produce nearly 10,000 new homeownership units. Moreover, in the next ten years, the City has committed to assist another 16,000 units primarily through the Partnership and Nehemiah home ownership programs. These efforts have proven successful not only in creating new homeownership opportunities for thousands of moderate income families who would otherwise not be able to afford them, but also in fostering community pride and strengthening the fabric of once deteriorated neighborhoods.

The City urges Congress to remove the restriction which prohibits the use of mortgage revenue bonds for newly constructed two- to four-family residences. Present law allows mortgage revenue bonds with existing two-, three-, and four-family homes, while prohibiting their use with newly constructed two-, three-, and four-family homes. Over 2,800 new two and three family homes constructed under the City's New Homes Partnership program will not qualify for mortgage revenue bond financing unless present law is changed. The City believes that there should be no distinction between new and existing two- to four-family residences and that both should be eligible for mortgage revenue bond financing.

Item 5: Modifications to the Mortgage Revenue Bond program concerning cooperative housing. The Mortgage Revenue Bond program (MRB) is well suited to single family or condominium residences and to the purchase and sale of individual cooperative apartments. However, several technical problems arise when an entire cooperative building is financed with an underlying MRB mortgage. The City supports several changes to the MRB provisions to make such mortgages more feasible.

The crucial difference is that the entire cooperative, not just a single residential unit, is financed by a single MRB. The sale by any unit owner does not extinguish the MRB liability and the project as a whole may have difficulty meeting requirements that are sensible in other contexts. For instance, if the owner of a single unit of housing, be it a single family house, condominium, or cooperative unit, wishes to sell for a price greater than the MRB price limits, he or she can do so by simply selling to someone who finances the purchase from a source other than MRBs. Where the entire cooperative is financed with MRBs, the MRB limits on resale continue to apply regardless of how the subsequent purchaser finances his or her purchase. Similarly the difficulties of starting up a large cooperative and the need to provide retail and parking services in a large building in a major urban area require modifications to the present MRB rules.

A. Income limits on resale. The acquisition cost limits on resale are lower than the acquisition cost limits for new units. In addition, the limits, which are based on median sales prices of new and existing housing, vary over time. In fact, the limits for new construction in New York City dropped 7 percent in 1992. Presently, the limit for existing housing in New York City is $20,000 less than for new construction. The practical effect of this difference is that a purchaser of a new unit who has to sell within a few years of his or her purchase may be forced to accept a sales price below the original purchase price. This effect will make it more difficult to sell units in the cooperative.

The City proposes that, in the case of a cooperative, the limit on resale be the greater of the limit applicable at the time of the purchase or the limit applicable at the time of the resale.

B. Interim rental use. The period required to sell the initial number of units necessary to make the cooperative a functioning and effective cooperative may require that, for sound financial reasons, some units may have to be rented on an interim basis. Such rental should not disqualify the units from being considered new construction nor jeopardize the MRB financing. The City urges the Congress to enact an amendment providing that interim rental for up to three years is permissible, that the period could be extended to four years with the issuer's consent if at least 75 percent of the units are sold and there is a good faith effort to sell the units, and that the purchase price limit applicable be the limit applicable to new construction.

C. Parking and retail use. Sound urban planning calls for the provision of retail services and parking facilities, not only for the residents of a cooperative building, but also for the general public. In fact, local governmental regulation or development requirements often specify such public amenities. The problem relative to the MRB rules comes from two sources. First, when the proportionate cost of the parking facility is added to a unit's purchase price, that unit may exceed the acquisition cost limits. Second, only 5 percent of the bond issue may be used for retail space. The City urges that:

- for parking facilities, the acquisition cost limits for any given unit not include the cost of parking facilities as long as the average unit cost (computed as total unit cost plus total parking cost) is less than the acquisition cost limit.

- for retail space, the applicable limit should be 10 percent where required by local government regulation or contract and such amounts should be excluded from the computation of a unit's acquisition cost.

Item 7: An exception to the private loan bond rules for certain housing bonds. The City urges Congress to repeal the discriminatory and difficult to administer $5 million limit on private loan bonds for certain housing loans and to direct the Internal Revenue Service to apply time value of money principles when determining if a bond complies with the rule.

The Tax Code limits the proceeds raised through tax exempt financing that can be "loaned" to five percent of the total proceeds of an issuance of governmental purpose bonds, with a maximum amount of $5 million out of any single issuance. Many tax-exempt bond provisions discriminate against large jurisdictions. The most damaging provision for the City of New York is the absolute $5 million cap on so-called "private loan bonds."

The result is that smaller jurisdictions may use the full 5 percent, while larger jurisdictions that issue in denominations of more than $100 million are limited to $5 million, no matter what their need. The City of New York, on the advice of its underwriters, issues between $500 million and $1 billion or more at a time. Consequently, the City is limited to about one-half of one percent for private loan bonds, about one-tenth what a smaller issuer can use.

Many of the City's low- and moderate-income housing programs involve loans to private individuals. The City often heavily subsidizes these loans -- especially the housing loans -- using its own funds, reducing the interest rate to between 0 percent and 3 percent. As a result, the subsidy by the City exceeds the federal "subsidy" provided through the tax exemption.

The result of the discrimination in the private loan bond provision is that the City has had to issue taxable bonds to finance some of its low- and moderate-income housing programs. Such taxable bonds bear an interest rate generally two percent greater than tax-exempt bonds. The additional cost to the City of these taxable issuances over the next ten years will be $142 million.

In addition to the discrimination inherent in the provision, the low absolute dollar limit has exacerbated problems in administering the provision, particularly defining what constitutes a "loan." The City believes that eliminating the cap would be a significant simplification provision. For instance, the City waited more than 18 months for an IRS ruling on one aspect of this problem. The IRS eventually ruled in the City's favor. The City had to submit a second ruling request on another aspect, which the IRS denied and the City may appeal. Even if the City were completely successful in these requests, however, the problems associated with administering the private loan bond provision would not be resolved. Removing the discriminatory $5 million cap, therefore, would not only be fair but would reduce the occasions when the complexities of the provision would cause problems.

The City proposes that the $5 million limit not apply to loans used to provide housing if (1) the issuer is a unit of general government, (2) the expressed security for the loan is the full faith and credit of the issuer, (3) the interest rate on the loan is less than the interest rate on the bonds, and (4). Further, the City proposes that when determining whether the loans exceed the 5 percent limit, the Internal Revenue Service should use time value of money principles, so that loans with an interest rate below the interest rate on the underlying bonds would be valued at a principal amount below their face value. As with other applications of time value of money principles, this change would allow the measurement of the actual loan to better reflect the economic reality of the transaction.

MISCELLANEOUS

Item 14: Extend the placed in service date for projects affected by section 204(a)(1)(E) of the Tax Reform Act of 1986. Section 204(a)(1)(E) of the Tax Reform Act of 1986 provides transition relief for an extremely important urban redevelopment project in Times Square, New York City. The project is publicly sponsored by New York City and the New York State Urban Development Corporation, but it is almost entirely reliant on private development and financing. It is a comprehensive plan to rehabilitate one of our nation's renowned landmarks - the Time Square-42nd Street area.

In addition to the extension of the placed in service date proposed, an important issue has arisen in connection with the fiscal 1994 reconciliation bill. The extension of the depreciation period in the House and Senate reconciliation bills can be read to apply even to projects that received transition relief in the 1986 Tax Reform Act, such as this project. This ambiguity should be corrected and the conference report on the reconciliation bill should provide an explicit provision stating that the lengthened depreciation period does not apply to projects that received transition relief in 1986.

The project's public benefits are immense. They include the elimination of blight and physical decay at the heart of one of America's great cities. The project will also reduce crime in the Times Square neighborhood. It will restore nine of the country's most historic theaters and will revitalize the 42nd Street area as an entertainment center. The project will provide thousands of jobs during the construction period. It will permanently increase employment in the area by more than six-fold.

Despite unforeseen delays due to litigation brought against the project by local property owners and a subsequently radically changed market for office buildings, the project has moved forward. The developers have expended significantly more than $250 million to pay for the public acquisition of what had been privately owned land, predicated on the tax treatment set out in the 1986 Tax Reform Act.

As a result of changed circumstances, the City, State and private developers contemplate the renovation of the historic theaters and interim low-rise development, and in the long term they continue to plan the development of the office buildings, a hotel and a trade mart. The Tax Reform Act of 1986 provides a transition rule for property that is an integral part of the project if it is placed in service before January 1, 1998. The transition rule provides 19 and 1/2 year, 175 percent declining balance depreciation for real property; pre-1986 ACRS depreciation for personal property; an investment tax credit; amortization of leasehold improvements over the lease term when that is shorter than the useful life of the property; and pre-1986 amortization of construction period interest rather than capitalization of the interest.

The City urges that, due to the changed circumstances, the significant amount of money invested by the private parties, and the substantial public benefits associated with this project, section 204(a)(1)(E) of the Tax Reform Act be amended to treat property as being placed in service by January 1, 1998 if at least $250 million was incurred or committed for development before April 15, 1993.

STATEMENT OF NORTHEAST PUBLIC POWER ASSOCIATION ON H.R. 2026, H.R. 1938

Submitted to

Subcommittee on Select Revenue Measures

June 30, 1993

The Northeast Public Power Association (NEPPA) welcomes this opportunity to state its views on two measures currently pending before the Subcommittee on Select Revenues:

* H.R. 2026, the Renewables and Energy Efficiency Incentives Act, sponsored by Rep. Jim McDermott; and

* H.R. 1938, a bill introduced by Rep. Richard Neal to eliminate the $15 million cap on private use that applies to tax-exempt bonds issued by public power entities.

NEPPA is the regional service association that represents more than 70 public power systems, joint action agencies and rural electric cooperatives in six states of the Northeast U.S. NEPPA member utilities serve approximately 1.5 million customers in Massachusetts, Connecticut, Rhode Island, Vermont, New Hampshire and Maine.

Issues relating to tax-exempt financing are of critical importance to the majority of NEPPA's members. Since 1980, NEPPA member utilities have issued over $1.7 billion in tax-exempt bonds, primarily for the construction of electric generating facilities.

H.R. 2026

NEPPA systems have taken an active role in the development and implementation of energy efficiency and demand-side management programs, and NEPPA supports the broad goals of H.R. 2026. However, NEPPA is strongly opposed to section 302 of the bill, which would curtail the use of tax-exempt bonds for the construction of new oil, coal or nuclear powerplants. NEPPA also opposes section 303 which would eliminate the tax-exempt status of rural electric cooperatives.

NEPPA believes that the limitation on the use of tax-exempt financing contained in section 302 is an unwarranted federal intrusion into the fundamental authority of state and local governments. Traditionally, the use of tax-exempt bonds to finance activities of state and local governments has been permitted if the facilities financed by those bonds are owned and operated by the governmental entity and the benefits of the facility are provided to all its citizens. Within those parameters, decisions about the types of facilities constructed and financed with municipal bonds are left to the discretion of government officials. Section 302 is a marked and disturbing departure from this traditional standard and is inconsistent with the principles of federalism.

Supporters of H.R. 2026 claim that the bill is intended to eliminate federal tax benefits for conventional fossil fuels and to "level the playing field" between renewable and nonrenewable sources of energy." However, H.R. 2026 fails the fairness test. It unfairly discriminates against public power systems and favors investor-owned utilities.

As noted in the testimony presented on June 24 by Stephen F. Johnson on behalf of the American Public Power Association, over 80% of the nation's conventional steam generating capacity -- most of which is fueled by coal, oil or petroleum products -- is owned and operated by private power companies. Yet H.R. 2026 does nothing to discourage future investment in such facilities by investor-owned utilities. Nor does it eliminate any of the tax benefits related to conventional fuel facilities that those utilities now claim. Instead, Section 302 of H.R. 2026 targets one segment of the utility industry -- public power systems -- and seeks to discourage future construction of coal, oil or nuclear power plants by denying the use of tax-exempt financing for those facilities.

This inequity is further compounded by the fact that the benefits to utilities from the bill flow exclusively to private power companies, not to public power or rural electric cooperative electric systems. Section 202, which allows electric and gas utilities to deduct from their tax liability the costs of demand-side management programs incurred since 1980, is applicable only to private power companies, not to consumer-owned electric systems that produce no profits and, therefore, do not pay federal taxes.

Eliminating the ability of public power systems to finance new fossil-fueled generation facilities with tax-exempt bonds will increase power supply costs and alter the competitive balance between public and private power in the U.S. When planning new resource acquisitions, public power systems will have to choose between financing conventionally fueled options with taxable bonds and higher cost renewable resources that could be constructed with tax-exempt issuances. Investor-owned utilities, on the other hand, would still be able to take advantage of tax benefits such as accelerated depreciation for all facilities, including generating plants fueled by oil, coal or nuclear.

For these reasons, NEPPA urges the Ways and Means Committee to oppose section 302 of H.R. 2026 and to use its best efforts to ensure that the any energy efficiency or renewable energy incentives provided to electric utilities under the bill are made available to consumer-owned utilities as well.

NEPPA also opposes section 303 of H.R. 2026, which repeals the tax-exempt status of rural electric cooperative utilities. Rural electric cooperatives, like public power systems, are not taxed because they operate on a not-for-profit basis. The elimination of this tax-exempt status does not appear to be linked to the energy policy objectives of the bill and should be deleted.

H.R. 1938

NEPPA supports H.R. 1938, a bill sponsored by Rep. Richard Neal which would eliminate the arbitrary $15 million cap on private use that applies only to bonds issued by public electric and gas systems. As the Subcommittee is well aware, the Tax Reform Act of 1986 reduced the private use test for tax-exempt bonds issued by all governmental entities from 25% to 10%. A separate provision of that Act imposed an additional private use limitation on public power bonds: the lesser of $15 million or 10%.

No abuses were identified as the rationale for this separate rule and no hearings were held on the limitation. No revenue estimate was made to determine the impact on the Treasury of the provision. In short, it appears to NEPPA that there is no sound public policy or financial justification for this discriminatory restriction.

The $15 million restriction limits public power's flexibility in developing, operating and using bond-financed facilities. In some cases, it causes less than optimum use of generating facilities because of the extremely small amount of surplus power that can be sold to non-exempt entities (including investor-owned and rural electric cooperative utilities) without jeopardizing the tax-exempt status of the bonds. NEPPA urges the Committee to adopt H.R. 1938 and to move the measure as expeditiously as possible.

Testimony of
The Business Roundtable

Introduction

ave 3/23

This testimony is submitted by The Business Roundtable to the House Subcommittee on Select Revenue Measures. The Business Roundtable is an association of chief executive officers of over 200 companies, who monitor and comment on public policy. The testimony relates to hearings on miscellaneous revenue-raising proposals, announced by the Subcommittee during August, 1993.

With regard to fiscal policy, The Business Roundtable believes that a lower budget deficit should continue to be the government's chief objective and that spending restraint should become the chief strategy for attaining it. We are convinced by experience that tax increases are not an effective strategy for deficit reduction.

Tax Policy Principles

Some of the revenue-raising proposals scheduled for the hearings manifest two undesirable trends that are eroding sound tax policy and principles regarding business income taxation.

> First is the trend toward legislating that ordinary and necessary business expenses, which are properly deductible under traditional income tax principles and practice, cannot be deducted.
>
> Second is the trend toward regarding the tax rules on international business as just another basket from which to fund piecemeal changes for revenue neutrality or deficit reduction. Many of these rules were written for an international economic order that passed long ago. But legislation has involved making marginal and uncoordinated changes to these out-of-date rules, instead of grasping the opportunity to change them fundamentally to mesh with the new international economic environment.

The Business Roundtable urges the Subcommittee to use its position and expertise to resist these trends, to educate that the full deductibility of ordinary and necessary business expenses is a necessary element of income taxation, and to recommend a comprehensive review of the taxation of international business.

Income taxation requires deduction of business expenses

Earlier this year, the President proposed and Congress legislated that certain business expenses will not be deductible for figuring income tax. They include employee compensation in excess of a dollar cap, half the cost of meals and entertainment incurred in connection with a trade or business, and all club dues and lobbying expenses incurred in connection with a trade or business.

This was done in the Omnibus Budget Reconciliation Act of 1993. It was done even though the expenses were and are widely acknowledged to be deductible under the standard theory and practice of income taxation. In fact, legislation was needed to deny these deductions precisely because otherwise they are deductible as valid business costs under standard principles of income taxation.

Regrettably, there are proposals scheduled for the hearings which similarly would deny, delay, or dilute the deductibility of valid business costs such as certain interest paid, environmental cleanup costs, and advertising costs.

Therefore, The Business Roundtable takes this opportunity to emphasize with the Subcommittee that business income taxation requires the full deduction of business expenses. The full deductibility of business expenses is not a "subsidy." It is the necessary ingredient to differentiate an income tax from a gross receipts tax. In other words, deductibility of business expenses is the necessary ingredient to achieve an income tax that is proportionate to the taxpayer's economic success instead of a gross receipts tax that is not proportionate to the taxpayer's economic success.

In sum, we believe that the Subcommittee should stand up for this basic principle of income taxation, should explain why it is a basic principle when the occasion requires, and should oppose revenue-raising proposals that would compromise it.

Comprehensive review of taxing international business is needed

The United States has a long way to go in order to attain a modern approach to the taxation of international business. Much of the law in this area is out of date, having been written when the United States dominated world markets. Additions over the years have made it indescribably complex, causing friction against economic development, administrative waste for both taxpayers and the government, and loss of understandability for both taxpayers and policymakers about what the rules are supposed to achieve.

A truly significant tax policy issue at this point is the need for the United States to modernize its rules for taxing international business so that they help advance America's interests in the modern global environment. A much inferior approach is to ignore this need and to add more disjointed pieces to the current ones.

Unfortunately, before the Subcommittee in these hearings are still more proposals, such as repeal of the foreign tax credit, that would add to the uncoordinated and anticompetitive tangle of tax rules on international business, with no evident attention to the much larger issues.

The Business Roundtable encourages the Subcommittee to consider the views of those who argue for a comprehensive reform, modernization, and simplification of America's international tax rules, particularly in the context of the new international economic environment. In the meanwhile, we believe that the Subcommittee should discourage piecemeal revenue-raising proposals bearing on international transactions.

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
THE HONORABLE CHARLES B. RANGEL (D-N.Y.), CHAIRMAN
A STATEMENT FOR THE PRINTED RECORD ON MISCELLANEOUS REVENUE-RAISING PROPOSALS
AS SUBMITTED BY THE NATIONAL SOCIETY OF PUBLIC ACCOUNTANTS
SEPTEMBER 22, 1993

On behalf of the twenty-two thousand members of the National Society of Public Accountants and their five million small business and individual clients, we would like to thank the House Ways and Means Subcommittee on Select Revenue Measures for soliciting input on the miscellaneous revenue measures currently before the subcommittee. Our members work on the front lines of taxation in America, and they have a unique view of the effect of taxes on a broad spectrum of taxpayers throughout the country. From mom & pops to major corporations, from below the poverty line to million dollar incomes, our members plan the finances and prepare the returns for the people you represent.

From our viewpoint as tax practitioners to this broad cross section of America, NSPA sees three problems with the proposals currently before the subcommittee. First, in the wake of the Revenue Reconciliation Act of 1993, further changes to the tax code at this point in time would prove to be an excessive burden on the taxpaying public. Second, many of the ideas currently under consideration by the subcommittee would further complicate the tax code at a time when government should be attempting to simplify the burden of voluntary compliance. Finally, several of the provisions under review would cause an unfair burden on those impacted by the proposals. These problems make consideration of these proposals at this time a bad idea, and therefore NSPA respectfully recommends that the subcommittee not advance another tax bill in this session of Congress.

PROBLEMS WITH FURTHER TAX LAW CHANGES

As tax practitioners and their clients currently struggle to comprehend and comply with the changes in tax law brought about by RRA '93, new tax laws and compliance requirements represent a burden that many simply cannot bear. Given the volume of retroactive provisions in the most recent law, taxpayers will spend the closing months of 1993 trying to ensure that they have not run afoul of laws that went into effect on January 1.

Vice President Gore's National Performance Review recommends that the IRS should improve collections through improved compliance efforts. NSPA notes that the more consistent the tax code, the simpler compliance becomes. Taxpayers and even practitioners have a difficult time keeping up with changes in the law as it is. If Congress heaps change upon change, voluntary compliance will decline not out of a desire on the part of the public to evade taxes, but simply out of the inability of any human being to keep up with the whirlwind changes made by Congress.

KEEPING THE TAX LAW SIMPLE

In keeping with the idea of simplicity in the tax code, NSPA's second concern with several of the provisions under consideration is the complexity that would be involved in administering and complying with them should they be enacted into law. The two clearest examples are the proposed amortization of advertising expenses and coach fare restrictions on travel deductions. Capitalization of a portion of advertising will lead to further amortization schedules, alternative minimum tax adjustments, etc. Just last month, Congress attempted to simplify this area by eliminating some adjustments for depreciation expenses. This proposal represents a giant leap backward toward a more complicated tax code which becomes far more difficult to comply with.

Even more frightening is the idea of limits on airfare deductions. While preventing abuse in the area of business travel is certainly a worthy goal, compliance with this provision would become an administrative nightmare. Businesses would be required to keep extensive records of every flight in order to show what fares were available, airlines would invent new terms for coach fares and the IRS would have to maintain an airline data base that would be the envy of every travel agent in America. Extensive regulations would inevitably follow as Treasury would attempt to define exactly what would constitute coach fare. All of this at a time when the average business is cutting costs at every opportunity, and abuses such as these are becoming fewer and much farther between. A provision like this would waste a lot of government effort to catch a relatively minuscule number of abusers.

FAIRNESS IN TAX LAW

Finally, NSPA would like to voice concern over several targeted provisions which would unfairly augment tax burdens which have already been increased this year by RRA '93. The 30% excise tax on association lobbying and the proposed increase in individual safe harbors for estimated taxes exemplify the provisions that would impose unfair burdens on taxpayers still reeling from the new law.

An excise tax on association lobbying expenses would further serve to silence a valuable source of information for government officials. Associations provide an important resource for legislators, whether they like it or not. The ability of an association to inform government officials of its members' views leads to more informed debate and better decisions for the country. On the heels of the disallowance of a deduction for lobbying expenses, further taxing these activities will drive many associations out of the government relations business, which will lead to government officials making decisions that are not fully informed. While this proposal might successfully raise revenue, the country simply can't afford it.

One provision of RRA '93 which NSPA approved was the simplification of individual estimated taxes. Our fear when we originally endorsed the proposal that Senator Bumpers put forth last spring was that a strict percentage such as 110% could easily be ratcheted up to squeeze more money out of taxpayers. Not a month after passage of this important simplification, Congress is already beginning to talk about this and NSPA wants its objection on the record from the start. Simplification in this area was worth 10%, but we oppose any further increase in the requirement for an estimated tax safe harbor for individuals.

In closing, we respectfully request that Congress consider the importance of consistency in the tax law as a stepping stone to improved voluntary compliance. Continually adjusting and changing the code, while attractive from a revenue standpoint, frustrates and confuses the American taxpayer. We ask that, given these considerations, Congress not consider a new tax bill this year.

Leroy A. Strubberg

Leroy A. Strubberg
Chairman, Federal Taxation
Committee

Jeffrey A Lear

Jeffrey A. Lear
Director, Federal Affairs
& Tax Counsel

STATEMENT OF THE NATIONAL COAL ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
September 15, 1993

My name is Richard L. Lawson, I am President of the National Coal Association, on whose behalf this statement is presented.

The membership of the National Coal Association consists of producing coal companies, whose operations comprise by far the majority of the production in the United States. In addition, we number in our associate membership equipment manufacturers, railroads, coal exporters, consultants and other related industries.

The American Mining Congress, an association of coal and non-fuel mineral producers, joins us in these comments.

We wish to comment on two proposals before the subcommittee.

These two issues concern (1) lengthening the ten year depreciable recovery period of coal mining equipment one to three years and (2) lengthening the period to amortize exploration and development costs incurred with respect to coal mining from 10 to 20 years.

These two proposals for some reason single out and blatantly discriminate against the coal industry. Most, if not all, of the major coal companies in the United States are (and have been) in an Alternative Minimum Tax (AMT) paying position for many years. Enacting these proposals would increase AMT liabilities even more, reducing already impaired coal industry cash flows.

With the U.S. economy in the dismal state it is today Congress should not be increasing AMT liabilities of any U.S. corporation. On the contrary, Congress should be decreasing AMT penalties enabling U.S. industry to have more capital to invest, hire employees and increase productivity.

These arguments, against the subject AMT proposals, were a basis for the AMT changes in the 1993 OBRA where a small measure of AMT relief was given taxpayers. Nothing has changed to single out the coal industry as a targeted business to increase its AMT costs.

Coal mining equipment's current AMT depreciable life of ten years is already a period of time that exceeds the normal life of most coal mining equipment. To lengthen a recovery period that already exceeds its normal useful life is unreasonable.

To double the recovery period of coal mining exploration and development costs from 10 to 20 years is even more unbelievable than the depreciable life AMT proposal. AMT already overly burdens mining taxpayers with a 10 year write-off versus the ordinary income tax treatment, basically a current year deduction. To lengthen this already inappropriate AMT recovery period one year, let alone 10 years, and only for coal industry taxpayers, is impossible to defend.

Rather than extending the tax lives of coal mining equipment, under AMT, they should be shortened.

Rapid depreciation methods are needed to encourage capital expenditures for new mining equipment. It is common knowledge that America's industrial complex has fallen far behind other countries in many areas of commercial endeavor. Depreciation for tax purposes should at least reflect actual business practices.

Our amortization periods, including those for mining equipment, generally exceed that of most industrialized nations. United States' businesses must compete with foreign competitors for both limited natural resources and available markets. Capital recovery is one of the significant factors which affect our ability to maintain our share of the world export coal market and also expand the nation's industrial base. A stable and favorable depreciation policy is a vital ingredient in justifying and encouraging current and future capital outlays in the coal industry.

The proposal to extend to 20 years the amortization period for mining exploration and development costs is highly discriminatory. The proposal is obviously an attempt to discourage the mining and use of coal, in favor of other fuels.

In fact, mining exploration and development costs are analagous to intangible drilling costs in the oil and gas industry, and should be treated for tax purposes in a similar manner.

Deducting intangible drilling costs for oil and gas is appropriate. The problem with oil and gas is to find it. Once found, there is little problem in producing and marketing the oil and gas. Accordingly, maintaining favorable tax treatment for intangible drilling costs is an entirely appropriate incentive for domestic exploration.

With coal, the problem is not exploring for it; we know where it is. The problem is producing coal at a sufficiently competitive cost, despite high rail rates and the costs of extensive government regulations to find the market niche that will lessen our dependence on imported oil.

The coal industry is already one of the most heavily regulated and taxed industries in the country.

Few understand the total burden of specific taxes and fees on a coal operation. Before a producer can think in terms of any profits that may be subject to state or federal income tax the coal producer:

- must pay operating expenses;
- must pay the landowner a royalty on the coal produced unless he has tied up his own capital in ownership;
- must, in most cases, pay royalties of around 8% of the selling price (12-1/2% in the case of federal leases on surface coal);
- must, in most cases, pay the state a severance or production tax ranging from 3-1/2 to 5% of the gross selling price for eastern coal to as much as 25% in the West;
- must pay from 3 to 10% of the selling price to the federal abandoned mined land fund to reclaim abandoned lands for which it had no direct responsibility; and
- must pay as much as 4.4% of the gross selling price into the Black Lung Disability Trust Fund for former miners that were not its employees.

- must pay state workers compensation premiums and federal and state unemployment taxes that often exceed 100% of salary along with the employer contribution for federal social security and medicare expenses and the federal superfund excise tax.

It is patently unfair and illogical to single out the coal industry, for whatever reason, and further burden, with increased taxes, a domestically produced energy which is the only energy product for which the United States has a positive trade balance.

In summary, singling out coal industry taxpayers in this fashion is discriminatory; is exactly contrary to last month's enactment of '93 OBRA; and, is illogical in the context of coal mining equipment's useful life. Lengthening the AMT amortizable life of exploration/development expenditures one more day, much less 10 years is inappropriate vis-a-vis its current ordinary income tax treatment.

Statement of the Coal Tax Committee Submitted for the Record to the Subcommittee on Select Revenue Measures of the Committee on Ways and Means

September 22, 1993

This statement is submitted on behalf of the Coal Tax Committee, which is comprised of several U.S. coal producing companies, including AMVEST Corporation, Drummond Coal Company, Peabody Holding Company, The Pittston Company, and The United Coal Company.

We would like to comment in opposition to two proposals before the Subcommittee: (1) an increase in the alternative minimum tax class life for coal mining equipment by one to three years; and (2) an increase in the alternative minimum tax amortization period for mining exploration and development costs incurred with respect to coal mining from 10 to 20 years.

These proposals inappropriately target the coal industry for harmful changes in the application of the alternative minimum tax at a time when a significant drop in coal prices and the burden of current federal and state taxes has made it increasingly difficult for the coal industry to respond to the current demand for coal. The coal industry is a key component of the U.S. economy, providing a stable and secure source of energy necessary to help our economy grow. Yet, the burden of federal taxation in combination with a low return on investment is crippling the ability of the industry to attract the capital needed to help the industry grow and expand in response to the growing demand for coal.

Coal is the largest domestic source of energy; nearly one-third of all energy produced in the United States is coal, and coal provides around 23 percent of all energy consumed in the United States. Some 55 percent of all electricity used in the United States is generated from coal. Domestic coal provides a secure, plentiful and reasonably priced energy source for producing the supplies of electricity necessary for sustained economic growth. At the same time, the coal industry has steadily made contributions to environmental improvement through air quality programs, the reclamation of mined lands, and the development of "clean coal technologies."

The price of coal, however, is at a 50-year low and the return on capital invested in the coal industry is at a low point as measured by either absolute or historical standards. The downward spiral in the selling price of coal has steadily reduced the operating profits in the industry which has resulted in some small producers being squeezed out of the business.

Coal is an important contributor to the U.S. economy, accounting for nearly 1.5% of GNP. Each job in the coal industry supports another seven jobs in support services. Yet, employment in the industry is still declining, down nearly 48% since 1980. This downward trend may well continue due to the low price of coal, mechanization, and the closing of unprofitable mines.

In addition, the coal industry is the most highly-taxed energy source, due to the imposition of general corporate income taxes, black lung taxes, severance taxes, retired miners taxes, mine reclamation taxes, and abandoned mine lands fees, as well as significant expenditures from royalty requirements and compliance with Clean Air Act-related rules. Penalizing the coal industry by further restricting the use of current law deductions under the alternative minimum tax system will seriously hamper the ability of the industry to meet the demand for electricity and exported coal. Some of our most profitable companies are paying combined Federal and state tax rates of over 70 percent of what would otherwise be their pre-tax income.

Public utilities depend on coal to produce electricity. Approximately eighty percent of U.S. coal production is used by utilities to generate electricity. The availability of coal assures utilities of a stable source of energy at competitive prices. Utilities now use coal to generate about 55% of the electricity consumed in the United States, up from 51% in 1980. The use of coal to generate electricity is expected to rise throughout the 1990's.

Unduly burdensome Federal taxation will do serious harm to the industry at a time when continued capital investment is badly needed. Coal producers have invested heavily in recent years to improve safety and productivity, to reduce costs, and to expand markets. The relatively low rate of return on these investments, however, is discouraging investment when substantial sums are needed to help the industry meet the growing demand for electricity and coal for export.

Coal exports overseas constitute a steadily increasing market and contribute some $4.6 billion yearly positively to the U.S. balance of payments. The United States does not subsidize our coal industry, but our foreign competition is subsidized. With the prices of coal having fallen dramatically over the last decade, and the number of U.S. coal companies and coal workers dwindling, this is not the time to impose greater tax burdens on U.S. coal. Additional taxes will make energy costs for U.S. citizens and industry less competitive, thereby adversely impacting our balance of trade.

With increasing frequency, many coal producers find themselves in a minimum tax position, resulting already in a significant cutback in the use of depreciation and the deduction of mining and development costs. The industry needs to be able to benefit from current law deductions, not have them further restricted, in order to strengthen profits and encourage investment.

The first proposal would lengthen by one to three years the AMT class life for assets used in coal mining (i.e., from a current class life of 10 years to a period of between 11 and 13 years). Depreciation deductions should have relevance to actual business experience and reflect the continuing need for capital investment in new equipment. This proposal will instead impede capital investment strategies, by reducing the cash available for necessary capital expenditures, as most coal contracts do not permit the pass-through of costs associated with changes in income taxes.

The second proposal would increase the AMT amortization period for mining exploration and development costs incurred with respect to coal mining from 10 years to 20 years. Again, this proposal fails to reflect actual business experience by significantly extending the AMT recovery period over the current AMT period, not to mention the regular tax rules, which allow for a deduction as a current expense.

In summary, these two proposals would have a significant negative impact on the members of the Coal Tax Committee, as well as many other coal producers. Many coal producers are already in weakened financial conditions, and all are currently subject to a plethora of income, excise and property taxes. Rather than reflecting accurate business experience or influencing consumer demand for coal, these proposals will instead prevent coal producers from maintaining and developing the levels of capital expenditures needed to respond to current demand for coal production.

The Honorable Dan Rostenkowski
U.S. House of Representatives
Washington, D.C. 20515

August 26, 1993

Dear Chairman Rostenkowski:

I'm writing to urge you to **oppose** a proposal set for presentation at a hearing to be held by the Subcommittee on Select Revenue Measures on September 8, 1993, dealing with captitalization and amortization of advertising expenses over a period of years.

A Federal tax on advertising would have a negative effect on the national economy and, in the long run, would likely decrease Federal revenues, rather than increase them.

In a capitalist economy, advertising has positive impact in many ways:

- Advertising boosts corporate profits, and thereby increases the tax base. Advertising also plays a part in jobs creation as advertisers' businesses grow and, thus, is a vital tool for economic growth.
- Advertising spurs competition. It is the most efficient of all marketing tools, and it helps lower prices by providing information to consumers in the most effective manner.
- Advertising pays for the vast majority of the news and information in a free society. A tax on advertising would continue to harm the media, which have seen a decline in revenues in recent years.

I believe that advertising should continue to be treated as all other ordinary and necessary business expenses and should not be taxed. In today's weak economy, a tax on the selling process is an especially bad idea.

Congressman Rostenkowski, please contact your colleagues on the Subcommittee on Select Revenue Measures urge their opposition to the advertising tax proposal.

Thank you.

Sincerely,

James P. Barth

James P. Barth
98 Cliff Road
North Bend, OH 45052

August 26, 1993

The Honorable Charles R. Rangel, Chairman
Subcommittee on Select Revenue Measures
1105 Longworth House Office Building
Washington, DC 20515

~~Dear Chairman Rangel~~: Charlie:

It has been brought to my attention that your subcommittee on Select Revenue Measures has scheduled hearings in September on a proposal that would require that a portion of all advertising expenses be capitalized and amortized over a period of years. I am writing to request that you reject any effort to limit the deductible of advertising expenses.

The reason this issue is important to Black Entertainment Television (BET) and other Black media companies is the simple fact that advertising is our lifeblood. If advertising expenses cannot be concurrently deducted as a legitimate business expense, it will dramatically reduce the amount of money that major companies spend on Black media at a time when we are all suffering a decline in ad spots or ad pages because of the on-going recessionary advertising spending climate.

As you know Charlie, many companies are already looking for an excuse not to use Black media. This proposal will undoubtedly make their decision that much easier.

I am sure that I speak for all of the Black media Chief Executives when I state that a free and independent Black media can only survive with continued advertising support. At a time when there is a growing need for positive Black voices, this is the absolute wrong time to propose legislation that will, in any way, shut off our ability to provide the diversity of ideas and images that are so critical to the future of Black America. Finally, the Congress needs to encourage the growth of Black-owned business, not stunt the growth of those that already exists which this proposal, if enacted, will do.

I would be delighted to meet with you to discuss this further at your convenience. In the meantime, I hope I can count on your support.

Warm regards,

Bob

Robert L. Johnson
President

cc: Members of the Ways & Means Committee
Members of the Subcommittee on Select Revenue Measures
CEO's of Black Media

CENTER FOR THE STUDY OF COMMERCIALISM
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September 22, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
House Committee on Ways and Means
Subcommittee on Select Revenue Measures
1102 Longworth House Office Bldg.
Washington, DC 20515

Re: Press release #9
Subcommittee on Select Revenue Measures
Hearing on Advertising Deductions
September 8, 1993

Dear Ms. Mays:

The undersigned organizations and academics are pleased to provide this written testimony for your hearing on miscellaneous revenue.

We are particularly troubled by the tax status that advertising currently enjoys. Corporations expense all of their advertising costs in the current tax year. That lowers the income tax paid to the federal and state governments.

Businesses devote at least $130 billion a year to advertising and promotion. Thus, the tax law saves businesses (and costs the federal government) as much as $34 billion, assuming that all advertising expenses were taxed at a 25 percent rate. That means that other taxpayers -- including low- and moderate-income individuals -- are subsidizing one fourth of all ad costs. At a time when most Americans are experiencing declines in real income, if not unemployment, it hardly makes sense to treat advertising, which is often frivolous and counter-productive to wise purchasing, in such a generous way. As one observer said, the whole purpose of advertising is to arrest human intelligence long enough to get money from it!

We urge the subcommittee to recognize the gravity of this nation's financial crisis and to amend the tax code so as to reduce the tax subsidy for advertising. We have two primary recommendations that would raise billions of dollars annually and that we believe would be welcomed by the general public:

1. Disallow as ordinary business expenses all advertising costs for alcoholic beverages and tobacco and all marketing programs aimed at children.

Alcoholic beverages and cigarettes contribute to hundreds of thousands of deaths each year and many millions of illnesses. Alcoholic beverages also cause tremendous social devastation, with the greatest effects felt by low-income and minority populations. The federal government, under both Democratic and Republican administrations, has had many programs aimed at reducing alcoholism and cigarette smoking. Congress has considered raising excise taxes and limiting advertising of those products to help reduce the health and social problems that they cause. Federal tax policies that subsidize the advertising of those products only undermine the effectiveness of the health programs. That just doesn't make sense.

If advertising and promotion expenses for alcohol and tobacco were not tax deductible, tax revenues would be boosted by about $1.5 billion annually (less, if companies spent less on advertising). Ideally, the increased tax revenues would be used to support alcohol- and tobacco-related health programs. [See: Description of Possible Options to Increase Revenues Prepared for the Committee on Ways and Means, Joint Committee on Taxation and the Committee on Ways and Means (June 25, 1987)]

Advertising aimed at children is one of the most dubious forms of advertising. In the late 1970s, the Federal Trade Commission was considering whether TV advertising directed to children is inherently unfair and should be banned entirely. (The Province of Quebec has decided that it was.) The FTC's inquiry was halted, and today, like in the late 1970s, a great volume of such advertising encourages young children to demand junky foods, junky toys, or lavish lifestyles.

If salesmen went door to door and asked parents, "May I speak to your children -- in private," they would be summarily ejected. But marketers have found that they can talk to and seduce children electronically at a much lower cost than they ever imagined. Many parents are incensed that ads encourage their children to want products that the parents feel are inappropriate or beyond their financial means. The very least the federal government ought to do to assist parents, and allow kids to grow up without such enormous commercial pressures, is to disallow advertising aimed at children as a tax-deductible business expense. Such a change would generate upwards of $125 million. Some of that revenue could be used to develop sorely needed educational programs and public-service announcements that could be broadcast during children's peak viewing hours.

2. Reduce the tax subsidy for all other forms of advertising by amortizing costs over several years.

It is illogical to require that capital investments be expensed over a period of years, but to allow advertising to be considered an immediately deductible business expense. A great deal of advertising has a long-term value in terms of brand recognition and loyalty. Most adults can sing advertising jingles that they heard in their childhood. Many people choose a product as a result of an advertisement and then continue to buy that product for many years. "Image" advertising, in particular, is meant not to sell a particular item today, but to persuade people to think well of the advertiser for many years into the future. Even a supermarket ad featuring a special sale encourages people not only to visit the store on Saturday, but to think of the store as offering high-quality, low-price merchandise and that they should shop at forever.

George Mundstock, professor of law at the University of Miami, reports that "...television advertising for consumer goods has been found to depreciate only about 20% a year....One study of selected firms found food, drug, and cosmetic advertising to last approximately 5.5 years." [U. Pa. Law Review 135:1179 (1987)] Steven Shore, an official at Broadcast Arts Inc., a New York producer of commercials, says, "Advertising is considered a long-term investment." (Washington Post, p. A6, Dec. 23, 1990)

Taxing advertising on the same basis as capital investments would level the playing field. Currently, tax law encourages companies to invest in advertising rather than new research equipment or production machinery. That result can only decrease business efficiency and American competitiveness. Lawrence Summers, formerly of Harvard University and now an assistant secretary of treasury, has written that expensing advertising:

> ...creates an unfair bias against investment in tangible equipment and in favor of investment in marketing and advertising. Fairness aside, this bias makes no economic sense. Unlike tangible investments, much of advertising cancels itself out as firms compete with one another for pools of customers. What little effect advertising has in increasing total spending is probably not desirable. With a national saving rate of two percent, the last thing the United States needs is a tax bias toward stimulating consumption. (The New Republic, Nov. 30, 1987)

A 1990 Congressional Budget Office report estimated that about $15 billion could be raised over 5 years, if only 80 percent of advertising costs were deductible. A study that the U.S. Small Business Administration conducted in 1989 for Congressman Richard T. Schulze found that limiting advertising deductions to 80 percent for businesses with annual receipts greater than $5 million would raise almost $4 billion per year. Professor Summers has estimated that allowing 40 percent of advertising to be deducted immediately and amortizing the remaining 60 percent over four years would raise $10 billion a year.[1]

In summary, changing the tax laws concerning advertising makes economic sense, would encourage companies to invest in efficiency-promoting equipment, and would generate $5 billion to $10 billion per year in new tax revenues. That revenue could help finance some of nation's crying needs, be it health-care reform, reducing the deficit, medical research, highway maintenance, or college scholarships.

Thank you for the opportunity to provide this testimony. We would be pleased to work with your staff further on an issue that we believe is of the utmost importance.

Sincerely yours,

Michael F. Jacobson, Ph.D.
Co-founder

For the undersigned:

Gar Alperovitz
National Center for Economic
Alternatives, Washington, D.C.

C. Edwin Baker
Nicholas Gallicchio Professor of Law
University of Pennsylvania

Center for Media Education
Washington, D.C.

Center for Science in the Public
Interest, Washington, D.C.

Center for the Study of Commercialism
Washington, D.C.

Dr. George Gerbner
Annenberg School of
Communications
University of Pennsylvania

Media Access Project
Washington, D.C.

National Consumers League
Washington, D.C.

Scenic America
Washington, D.C.

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[1] Alternatively, the tax code could simply permit as a business deduction 50 percent or 75 percent of a company's advertising expenditures. A small-business exemption could be included.

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August 20, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

I am writing in response to your request for comments on the potential revenue-raisers to be considered by the Subcommittee on Select Revenue Measures in September. One of the items on that list, the deferral and amortization of advertising expense, has been proposed on many previous occasions and, inevitably, shelved in the wake of fierce opposition. This will probably be its fate this time as well, but I hope that the Committeee will give it some careful consideration before abandoning it.

Those who support the immediate deduction of all advertising expenses in the year incurred maintain that this is just another ordinary and necessary business expense. It is deducted currently in the taxpayer's financial statements, any long-term benefit is conjectural at best. Others argue that advertising serves two purposes: the instant appeal to the current consumer and the creation of long-term brand loyalty.

Perhaps the most eloquent testimony to the latter objective is in the 1990 annual report of PepsiCo, Inc., the enormously successful owner of Pepsi-Cola, Frito-Lay, Pizza Hut, Taco Bell, and Kentucky Fried Chicken. The cover features a photo of a sumo wrestler, with the caption "The Power of Big Brands." Inside, CEO Wayne Calloway makes the following excellent points in his letter to shareholders:

> "On the one hand, PepsiCo is in the business of selling soft drinks and snacks, as well as a whole lot of chicken, tacos and pizzas. But we're really in the business of building brands. Like the sumo, these brands are big and powerful."
>
> "Obviously, a lot goes into a successful business, from management talent to wise use of cash. But for a consumer products company, one of the most basic factors is the ability to create and sustain brands that consumers love, year after year after year."
>
> "Eight of our brands-Doritos, Ruffles, KFC Original Recipe Chicken, Pizza Hut Pan Pizza, Pepsi, Diet Pepsi, Mountain Dew and 7UP-achieve a billion dollars in retail sales every year. Twenty-five more brands achieve at least a hundred million."

> "Rare are those things that command our trust and loyalty for very long. Yet those are precisely the factors that define a brand, and make the big brand 'hall of fame' so exclusive. It's not easy to enter. But once inside, consider some of the advantages you enjoy.
>
> - **Big Brands Stand the Test of Time**
>
> - **Big Brands Grow in Good Times and Bad**
>
> - **Big Brands Lead to a Lifetime of Loyalty"**

How do companies build long-lasting big brands? With advertsing - in PepsiCo's case, some of the most brilliant advertising ever devised. So it is not unreasonable for Congress to insist that some portion of the annual advertising expense be capitalized and amortized over time.

My recommendation is that half of a company's otherwise deductible advertising expense in excess of $10 million should be amortized over fifteen years, which is the same period that now applies to purchased goodwill. The $10 million floor would protect small companies and start-up enterprises, while the 50% immediate deduction would recognize that some advertising does relate to short-term promotions that really are one-time expenses.

The consumer product giants and their advertising agencies and lobbyists will, undoubtedly, complain that they are being singled out for punitive tax treatment. If so, they should be reminded that manufacturing companies do not get an immediate deduction for purchasing or constructing the productive assets that drive their profitability. In fact, new factories, which may not last nearly as long as the major consumer brands created and nurtured by advertising, must now be depreciated over 39 years, and there is no more investment tax credit for machinery and equipment. Moreover, the IRS has already recognized the long-term nature of some brand promotion expenses by seeking to capitalize package design costs.

Thank you for taking the time to read this letter. I wish you and the Committee well in all of your deficit reduction efforts.

Sincerely yours,

Jim Ditkoff

James H. Ditkoff

[AN ATTACHMENT TO THIS LETTER IS BEING RETAINED IN THE COMMITTEE FILES.]

EDWIN L. COX COMPANY
2200 ROSS AVENUE, SUITE 3600
DALLAS, TEXAS 75201
(214) 220-3636

September 30, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U. S. House of Representatives
1102 Longworth House Office Bldg.
Washington, DC 20515

Re: Ways and Means Select Revenue Subcommittee
Press Releases #9 and #10

Dear Ms. Mays:

This letter is to register my opposition to "require that a portion of advertising expenses by capitalized and amortized over a period of years".

Generally accepted accounting principals require that advertising be expensed currently, the theory being that advertising expenses relate directly to today's business and should not be deferred. It is good accounting theory because it follows the business purpose for advertising. Any deviation from that practice for tax purposes would be a travesty because it would be bad theory and would artificially discourage companies from advertising.

I cannot emphasize too strongly my opposition to any change in tax law as it applies to advertising expenses.

Sincerely,

J. Oliver McGonigle
President

JOM/am

John J. Fisher
122 SCHOONER LANE
BARRINGTON, IL 60010

August 27, 1993

The Honorable Rostenkowski
United States House of Representatives
Washington DC 20515

Dear Congressman Rostenkowski,

I have just learned that your Ways and Means Committee is considering a proposal to limit the deduction of advertising as a business expense.

I am outraged, and to turn a phrase, "ain't going to take it anymore!" You have already destroyed the real estate market by eliminating deductions, you have passed taxes on me, my retired parents and now you're trying to strike right into the heart of a major service industry. **SERVICE IS ALL WE HAVE LEFT IN THIS COUNTRY**, your high taxes and pro labor programs have driven most major industries to foreign markets.

The advertising industry is already depressed and your proposal will only kick it when it is down. To advertise one's products is a NECESSARY and proper business expense. You are striking right at the heart of what makes us great. You have been a fair and strong leader for what is best for our country in the past. I hope your current problems do not stop you from standing up for what you must know is right for our industry.

Sincerely,

John Fisher

John J. Fisher

TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES

WRITTEN STATEMENT FOR THE PROPOSAL TO CAPITALIZE A PORTION OF ADVERTISING EXPENSES

I. INTRODUCTION

The following written statement, which is submitted jointly by the **Food Marketing Institute** and the **International Mass Retail Association**, is presented in opposition to the proposal to capitalize a portion of advertising costs and amortize them over a period of years

The **Food Marketing Institute (FMI)** is a nonprofit association which conducts programs in research, education, industry relations and public affairs on behalf of its 1,500 members -- food retailers and wholesalers and their customers in the United States and around the world FMI's domestic member companies operate approximately 19,000 retail food stores with a combined annual sales volume of $190 billion -- more than half of all grocery store sales in the United States FMI's retail membership is composed of large multi-store chains, small regional firms and independent supermarkets. Its international membership includes 250 members from 60 countries.

The **International Mass Retail Association (IMRA)** is a trade association representing more than 650 members -- 150 mass retailers that include discount department stores, home centers, warehouse clubs, and off-price stores, as well as over 500 suppliers Collectively, IMRA retail members operate more than 54,000 stores in the U S and abroad and employ more than 1 5 million people The IMRA retail members represent the overwhelming majority of the $202 2 billion mass retail industry in the United States.

As a general rule, the members of both FMI and IMRA advertise consistently on a daily and weekly basis Significant resources expended on advertising are vital to notify customers of new products and/or weekly specials The benefits derived from this advertising expire at the end of a seven-day period

Advertising costs are clearly a cost of doing business with no ascertainable benefit lasting beyond one year. There is no sound tax policy justification for requiring amortization of a portion of advertising expenses. Therefore, businesses should be allowed to continue to deduct these costs as they are incurred

II. ADVERTISING IS AN ORDINARY AND NECESSARY BUSINESS EXPENSE THAT SHOULD BE DEDUCTIBLE BECAUSE IT HAS AN IMMEDIATE AND PREDICTABLE AFFECT ON THE LEVEL OF SALES

Our tax system has traditionally recognized that taxation is based on net income, not gross receipts or gross income Consequently, taxpayers are allowed a deduction for all ordinary and necessary business expenses. Advertising is an operating cost which is deductible from gross revenue to calculate income or loss for the taxable year because its useful life does not extend beyond one year Advertising in the mass retail industry and retail supermarkets has always had an immediate and predictable effect on the level of sales. In fact, there is a direct and immediate correlation between the level of advertising and immediate, increased sales Advertising, in an industry like mass retail and supermarket retail, experiences such a quick level of turn-over that the benefits from advertising depreciates well within one year In fact, mass retailers and grocers often use 7-day advertising statements. That is, most of their advertising is directed toward a 7-day turnaround on either new items or weekly special prices and the advertising expires at the end of such period.

It has long been recognized that an advertising expenditure is an ordinary and necessary business expense which is afforded a deduction in the taxable year in which it occurs Recently, in fact, the Internal Revenue Service in Revenue Ruling 92-80 makes clear that the cost of ordinary product advertising is an expense. The ruling states that only in the unusual circumstance where advertising is directed towards obtaining future benefits significantly beyond those traditionally associated with ordinary product advertising or with institutional goodwill advertising, must the cost of that advertising be capitalized.

Moreover, economic studies have substantiated that the benefit of advertising is used up within one year. Dr. Kenneth J. Arrow and Dr. George G. Stigler, two Nobel Laureates in economics, co-authored a recent study on the subject. Both conclude that advertising depreciates so rapidly that virtually all of its effects are gone within one year.

III. ANY ASSUMED LONG-TERM BENEFIT THE RETAILER RECEIVES FROM ADVERTISING, ASIDE FROM INCREASED SALES, IS AN UNDETERMINED, INDEFINITE BENEFIT

Unlike goodwill which has a specific dollar amount allocated in a business acquisition, long-term benefits derived from advertising are uncertain and indefinite. Factors attributable to goodwill, such as employee service and community reputation, are not items that are amortized. In fact, employee salaries are deductible as an expense in the year paid, even though the benefits of hiring an outstanding employee will likely last beyond one year. Even assuming that advertising expenditures produce a benefit beyond one year, it is uncertain and indefinite. Again, the focus of product advertising is an immediate benefit, as evidenced by the expiration of the advertising period. Therefore, an attempt to allocate a portion of advertising which lasts beyond one year is an impossible, if not futile, effort.

IV. THERE IS NO JUSTIFIABLE POLICY BASIS FOR CAPITALIZING ADVERTISING COSTS; SUCH A PROVISION WOULD INCREASE THE COMPLEXITY OF THE TAX CODE.

The proposal to require a portion of advertising expenses to be capitalized and amortized over a period of years would add great complexity to an already extremely complex tax code. It would be extremely difficult to determine with reasonable certainty that the advertising created benefits resulting in later years from the expenditure.

Historically, efforts by taxpayers in the early years of income taxation to capitalize advertising costs were opposed by the IRS on the grounds that allocating advertising expenditures between current expenses and capital outlays were not feasible. A requirement to capitalize advertisements will require affected retailers/wholesalers to expend a significant amount of time and effort to accumulate the data necessary to make the required adjustments. Making determinations as to the definition of advertising, the portion allocated for capitalization, and the capitalization period, will increase the complexity of the tax code and create uncertainty for accurate compliance. Consider the following items which may or may not be characterized as advertising: business cards, discount coupons, promotional gifts, mailing costs of ads, printing costs of ads, etc. Trying to distinguish between advertising expenditures and marketing expenditures would be extremely difficult, if not next to impossible.

The added complexity will only add more costs for the government in the form of audits and litigation over distinguishing between those expenditures characterized as advertising and certain expenditures which are not.

V. CONCLUSION

The Food Marketing Institute and the International Mass Retail Association are strongly opposed to any proposal which would alter the deductibility of advertising. Not only is the proposal bad tax policy, but it would severely harm businesses which rely heavily on advertising to compete. In a climate where businesses are struggling to meet increasing regulatory burdens and comply with a complex tax code, such a proposal would further harm businesses' ability to stay competitive in the marketplace and create numerous controversies with the IRS over the proper definition of advertising.

STATEMENT OF MATTEL, INC. REGARDING THE PROPOSAL TO CAPITALIZE ADVERTISING EXPENSES BEFORE THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES

SEPTEMBER 20, 1993

The House and Ways and Means Subcommittee on Select Revenue Measures is considering a proposal to limit the current business deduction for advertising expenses. Mattel, Inc.'s position is that the requirement to capitalize and amortize advertising costs over a certain period is unsound from an economic and tax policy perspective. Mattel position is based upon the following:

- Advertising expenses are and should continue to be currently deductible because they are generally incurred to produce current revenues; and
- Advertising has a positive effect on businesses and consumers because it encourages product innovation and price competition.

ADVERTISING EXPENSES PRODUCE CURRENT REVENUES

Generally accepted accounting principles (GAAP) support the current write-off of advertising and promotion expenditures. GAAP generally requires that advertising be deducted currently and allows the capitalization of advertising expenses only in very limited circumstances. This position has recently been reviewed and affirmed by the American Institute of Certified Public Accountants (AICPA) and the Financial Accounting Standards Board. The AICPA concluded that capitalizing advertising expenditures should not be permitted due to the difficulty in identifying and isolating the future benefits that arises from those expenditures.

Mattel's continued business success is dependent upon its ability to design, manufacture and market toy products. In this regard, Mattel regularly refreshes, redesigns and extends existing product lines and develops innovative new product lines. Generally, the product life cycle of Mattel's new and existing products is approximately one year. Product lines such as BARBIE must be refreshed annually to add new features and/or keep up with current trends to maintain interest by children.

Mattel supports its new and existing product lines with extensive advertising and consumer promotions. Mattel advertises and promotes its products at varying levels throughout the year, especially during the Christmas season. Advertising includes television and radio commercials and magazine and newspaper ads. Promotions include in-store displays, coupons, merchandizing materials and major events focusing on products and tie-ins with various consumer product companies. Advertising is critical to the successful introduction of new products and refreshing or extending existing product lines.

Mattel's experience is that advertising and promotion expenses are associated with the generation of current income. Mattel's advertising and promotion expenditures generally notify customers of the following:

- Information about new or existing products;
- current price information; and
- retailers who stock the products.

Mattel must continually advertise its products due to the constant refreshing of existing product lines and introduction of new product lines. Our advertising focuses on specific products and promotions during a certain marketing period. The requirements to capitalize advertising expenses would be contrary to Mattel's experience that advertising and promotion expenditures do not create a measurable future benefit. Rather, Mattel believes that advertising and promotion expenses should be currently deductible at the same time as the revenues to which it relates is recognized.

POSITIVE BUSINESS EFFECTS OF ADVERTISING

For Mattel, advertising is the most efficient marketing tool that helps to lower prices by providing information to a large number of consumers in a short period of time in the most cost-effective manner. Mattel's innovative advertising and promotion strategies provide for competitive advantages in the U.S. and foreign markets.

In Mattel's case, we believe that advertising expenditures have little benefit beyond the period in which the expenditures are incurred. As a result, Mattel must continuously advertise and promote its products throughout the year to support current demand for its product lines. Therefore, we strongly recommended that the House Ways and Means Subcommittee on Select Revenue Measures conclude that advertising expenditures should continue to be currently deductible for federal income tax purposes.

MILES

Helge H. Wehmeier
President and
Chief Executive Officer

September 9, 1993

The Honorable Charles B. Rangel
Chairman
House Committee on Ways and Means
Select Revenue Measures Subcommittee
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Congressman Rangel:

We understand that the Select Revenue Measures Subcommittee of the House Committee of Ways and Means is currently holding hearings on various revenue issues, including a requirement that a portion of advertising expenses be capitalized and amortized over a period of years.

Miles Inc. is the largest nonprescription drug manufacturer in the State of Indiana and the largest employer in Elkhart county, with over 3,000 employees. To a health care company like Miles, any proposal which limits the immediate deductibility of advertising expenses would severely limit the dissemination of information to consumers, limiting their ability to make intelligent choices on nonprescription products.

Such legislation seems contradictory to health care reform where self-medication products can be a cost effective choice for some ailments.

We urge advertising expenses continue to be given immediate deductibility as both a very necessary and effective business expense and as a continuing necessary component of health care reform.

Sincerely,

Miles Inc.
One Mellon Center
500 Grant Street
Pittsburgh, PA 15219-2502
Phone: 412 394-5551

Statement to the Subcommittee on Select Revenue Measures
Committee on Ways & Means
U.S. House of Representatives
by Ronald B. Weinel, Vice President, Taxes
Ralston Purina Company

We wish to express our strong opposition to any proposal to limit the deductibility of advertising expenses.

Ralston Purina Company is a consumer products company. Among its many products, the company produces **Purina** dog and cat foods, **Eveready** and **Energizer** household batteries, **Chex** breakfast cereals, **Beech-Nut** baby foods, cookies, crackers and snack foods, and dietary soy proteins. The Continental Baking group of Ralston Purina is the largest wholesale baker of fresh delivered bakery products in the United States with such popular brands as **Wonder** breads and **Hostess** sweet baked goods. Outside the United States, Ralston Purina International is a major producer of livestock and poultry feeds. In 1992, the company had sales of more than $7.7 billion.

"A proposal to require that a portion of advertising expenses be capitalized and amortized over a period of years" is listed as a revenue-raising proposal to be addressed at hearings by the Subcommittee on September 8. This description of the proposal obviously does not give sufficient information to indicate how it would work.

However, the Congressional Budget Office has analyzed a proposal requiring advertisers to amortize 20% of their advertising expenses over 4 years. CBO estimates that this proposal will raise $17.5 billion in 5 years.

Severe Short Term Impact

Depending upon how advertising is defined (which is a difficult issue in itself), requiring capitalization and amortization over 4 years of 20% of such advertising could substantially increase Ralston's taxes. In 1992, Ralston incurred $931 million of world-wide combined advertising and promotion expenses. Of that amount, $776 million was deductible in Ralston's U.S. income tax return.

Without a definition of what would constitute capitalized advertising, we cannot accurately estimate the actual effect of the proposal. However, for every $100 million of defined advertising incurred, a corporate taxpayer will, after the initial four year amortization period, incur a permanent $17.5 million increase in corporate income tax.

Exhibit I (attached), assumes advertising expenditures do not grow. If the taxpayer's expenditures are growing, the tax cost is higher.

Therefore, the tax would reduce significantly the cash flow of our company. This negative effect is in addition to and greater than the tax increase imposed on Ralston by the recent Budget Reconciliation Act of 1993. That tax increase is a multimillion dollar tax burden for our company.

At a time when our company already faces heavy competitive pressure in the market, a tax increase of this magnitude would have a severe effect. It could compel several actions, including a cutback on advertising, a further examination of expenditures for employees, new plant and equipment, administrative costs, dividend policy, etc. in an effort to recover the higher tax costs. In view of the President's efforts to create new jobs, such a tax proposal is at odds with the Administration's objectives. It seems particularly ill advised in the context of existing economic conditions.

Importance of Advertising

The advertising tax has an especially adverse impact for us because we are in highly competitive businesses. In our very competitive markets, we might not be able to pass the tax on to the consumer in the form of higher prices. Instead, we will be forced to cut back on some corporate expenditures in an effort to maintain the financial strength and health of the company.

In breakfast cereals for example, there are many new products coming on the market all the time. To survive, we have to advertise and tell consumers about our new products. If an "advertising tax" raises Ralston's taxes, it also raises the cost of Ralston's ability to compete.

This is strong connection between advertising and new product development and technology.

In recent times, we've been producing more and more new products that are directed at the health needs of people (and animals). We've increased fiber content, reduced fat and calories, and eliminated saturated fat. We tell consumers about these new products through advertising. If there is an increased burden on advertising, it reduces our ability to tell people about our new products.

Clearly, Americans are getting healthier, and it's due in part to better diet. There is a lot of new public information about the connection between diet and health. The Federal Trade Commission has published a report showing that food industry advertising is much more effective than the government in getting information out to people about how to improve their diet. Undoubtedly healthier diets help to hold down health care costs.

Likewise, we have entirely eliminated mercury content from our Eveready batteries to improve the environment. We need to get the message to our customers.

The ad tax would put a needless financial burden on our ability to tell people about our products and our new technologies. It would raise the already high financial developing new products and may reduce the number of new products brought to market.

Definition Problem

The proposal to capitalize advertising expense presents a major challenge in developing an administratively workable definition of what constitutes "advertising expense". Beyond the radio, television and print media categories, how would consumer coupons, premiums and rebates be handled? Would it make a difference whether the coupon was in a newspaper, an insert in a newspaper, or in a store aisle dispenser fastened to the shelf by the product?

The 1986 Tax Reform Act made a serious attempt to simplify the tax code. Much more simplification is needed. A limitation on the deduction for advertising will go the opposite direction. It will complicate the lives of taxpayers for years to come while a clear definition of advertising is sorted out by the IRS, by the courts, and probably by Congress.

Effects of an Ad Tax

Consumer products companies, like Ralston, are already paying taxes at nearly the maximum rate. The attached Exhibit II shows the effective tax rates of eleven food and non-food consumer products companies. From the published annual reports of these eleven companies, we prepared the attached exhibit. Their effective tax rates of these companies generally range from the upper 30's to the low 40's over the past three years. The advertising tax proposal would further raise taxes on the very companies that already are high rate taxpayers. In addition, it would reduce our ability to compete, to develop new and better products and tell consumers about them.

Promotion expenditures must be constantly incurred to sell the products. Unless done continuously, advertising quickly losses it effectiveness, as consumers forget the message. The information overload in our technological society intensifies this tendency. To require capitalization and amortization of any part of advertising and promotion expenditures is based on the erroneous presumption of long-term effectiveness. These expenditures should continue to be deductible when incurred.

We question the revenue by the CBO of $17.5 billion over five years from enactment of the proposal. Advertising would become more expensive for business compared to other means of promoting the sale of products. Expanding the number of sales representatives, reducing the price of the products to retailers, or using other marketing programs could offset some of the previous advertising expenditures. This would increase the tax base on which the additional revenue was projected. Also, it would introduce yet another significant government interference into business decisions regarding the most efficient manner of conducting operations to make profits adequate to attract capital.

A trend is already developing in the consumer products industry toward "Everyday Low Pricing" where the manufacturer reduces its advertising and marketing expenses to sell the product to the retailer at a lower price. If this practice becomes more broadly established, the advertising expenditures could decrease significantly over the next several years.

For all of the foregoing reasons, we strongly oppose any proposed limitation on the deductibility of advertising expenses (however defined), and we urge the Subcommittee to reject any such proposal.

September 9, 1993

Exhibit 1

AMORTIZATION OF ADVERTISING COSTS

Advertising Expenses	$100,000,000
Amount To Be Capitalized	$ 20,000,000
Annual Amortization	$ 5,000,000

	Year 1	Year 2	Year 3	Year 4	Year 5
Capitalized	$20,000,000	$20,000,000	$20,000,000	$20,000,000	$20,000,000
Amortization		(5,000,000)	(5,000,000)	(5,000,000)	(5,000,000)
Amortization			(5,000,000)	(5,000,000)	(5,000,000)
Amortization				(5,000,000)	(5,000,000)
Amortization					(5,000,000)
Total	$20,000,000	$15,000,000	$10,000,000	$ 5,000,000	$ 0
Tax @ 35%	$ 7,000,000	$ 5,250,000	$ 3,500,000	$ 1,750,000	$ 0

Total Tax Cost - $17,500,000 - over first four years. This effectively becomes permanent in nature assuming no growth in expenditures.

Thus, the CBO proposal appears to assume that advertising expenses must be $100 billion annually to achieve tax revenue of $17.5 billion over five years assuming no growth in advertising.

Exhibit II

Effective Tax Rate of Food and Non-Food companies

	Total Effective Tax Rate			Domestic Effective Tax Rate (1)		
Company Name	Current Yr	Prior Yr	3 Yr's	Current Yr	Prior Yr	3 Yr's
Ralston Purina	40.89%	39.50%	39.50%	38.41%	42.27%	41.15%
FOOD:						
Campbell's	38.63%	39.84%	97.55%(2)	41.39%	42.33%	50.08%
MultiFoods	37.65%	42.00%	46.88%	41.10%(3)	47.20%(3)	39.40%(3)
Quaker	41.26%	42.70%	40.14%	41.74%	41.07%	39.14%
Coca-Cola	31.40%	32.11%	31.40%	33.20%	26.10%	22.14%
Kellogg's	36.21%	38.43%	38.28%	34.75%	36.37%	34.81%
NON-FOOD:						
General Mills	40.04%	40.13%	39.37%	38.78%	39.42%	40.70%
Pepsi	31.45%	34.92%	34.05%	38.45%	41.72%	47.81%
American Brands	36.79%	34.89%	43.56%	41.30%	39.35%	62.97%
Borden	27.88%(4)	36.02%	36.83%	13.98%(4)	35.68%	35.44%
Philip Morris	42.62%	43.67%	43.91%	40.96%	43.32%	45.60%

(1) In some cases the annual report did not isolate domestic deferred tax data. Therefore, the domestic calculation may include a minimal amount of deferred foreign tax data.

(2) Due to non-deductible divestitures, restructuring and unusual charges.

(3) May be inaccurate due to insufficient information.

(4) Borden reported a large loss therefore, the rate is distorted.

WRITTEN STATEMENT OF

THE RETAIL TAX COMMITTEE OF COMMON INTEREST

I. INTRODUCTION

The Retail Tax Committee of Common Interest respectfully submits these comments regarding the proposal to limit the current business deduction for advertising expenses.

The Retail Tax Committee of Common Interest is a long-standing group of large retail businesses organized to address its members' concerns on Federal and local tax issues. Our member companies operate in all 50 states, with thousands of facilities and over 1 million employees. The membership of the Retail Tax Committee includes Carter, Hawley, Hale Stores, Inc.; J.C. Penney Company, Inc.; The Limited; R.H. Macy Company, Inc.; Melville Corporation; Sears Roebuck and Company; P.A. Bergner & Co.; The Gap, Inc.; Tandy Corporation; and Walmart Stores, Inc.

The retail industry is one of the most basic industries in this country, providing employment on the local level for thousands of workers. Frequently, employment in retail activities or industries that serve the retail sector are the mainstay of a local economy.

We believe that the adoption of a proposal to limit the current business deduction for advertising expenses would be bad tax policy. Such a proposal would result in the mismeasurement of taxable income, limit the availability of information to consumers, and increase complexity.

Any limitation on the current deductibility of advertising expenses would have a direct and negative effect on the retail industry. Retailers use advertising to inform their customers what they have for sale and for what price. Any limitation on the current deductibility of advertising would create artificial economic barriers to the presentation of that information by increasing its cost. This would in turn decrease the amount of advertising, leading to reduced sales and an overall decline in the amount of economic activity that could otherwise be achieved.

II. CURRENT DEDUCTIBILITY OF ADVERTISING CORRECTLY MEASURES TAXABLE INCOME

Retailers use advertising to communicate to customers what items they have for sale at what price on a day-to-day basis. Advertising expenditures are a cost of current sales, not future sales. Any provision that would delay the deduction of advertising expenditures into the future would result in a mismatching of income and expense for the retail industry.

A retail advertisement that list goods for sale at specified prices is by its nature of temporary value in attracting customers and stimulating sales. In modern retailing, the list of products offered and selling prices changes frequently. An advertisement that lists yesterday's goods at yesterday's prices makes no contribution to the sale of today's goods at today's prices.

It is our experience that advertisements have a substantial impact when the advertisement runs, but only a greatly reduced impact thereafter. Consumers seeking to purchase a new set of sheets may be attracted by one retailer's advertisement announcing a sale, but are likely to go to a second retailer if they wait until the following week when the second retailer is advertising its sale and the first is not. Unless refreshed with a new advertisement, the ability of the previous advertisement to stimulate sales quickly slips away.

This necessity to continually provide new advertisements is one reason advertising has consistently been treated as a current expense for both tax and financial accounting purposes. In the absence of the new advertisement, the old advertisement has little impact on sales. Even in the case of so-called "institutional advertising", (advertising that is designed to stimulate name brand recognition rather than offer a specific good for current sale) advertisements or other promotional activities must be continuous to maintain the consistent stimulation of new business.

Retail advertising stimulates current sales and is a cost of producing current income. No definitive evidence exists of its impact on future sales in future years. To require capitalization of an arbitrary portion of advertising expenditures and relate those costs to sales in the future is simply inaccurate.

III. CAPITALIZATION OF ADVERTISING WOULD REDUCE THE AVAILABILITY OF INFORMATION TO CONSUMERS

The primary purpose of advertising is to inform consumers. Advertisements are used to notify individual and business customers of current prices, provide information on new products or improvements in current products, direct consumers to retailers that stock the product, and provide other types of information consumers use in making their buying decisions.

In our experience as retailers, advertising is a vital component of a competitive market place. Competitive pricing exists where advertising makes information on prices efficiently available to consumers. Advertising also plays a central role in informing consumers of the relative benefits of competing products.

Requiring an arbitrary portion of advertising expenditures to be capitalized artificially increases the cost of advertising. In response to this increased cost, some advertisements will not run. The resultant decrease in the availability of information to consumers will result in less informed consumers and a less competitive marketplace.

IV. CAPITALIZATION OF ADVERTISING EXPENSES WOULD INCREASE COMPLEXITY

A requirement that an arbitrary portion of advertising expenditures be capitalized and amortized would increase complexity for both taxpayers and the Internal Revenue Service.

In order to implement such a rule, it is necessary to determine which expenditures are advertising expenditures. New definitions will have to be written and regulations promulgated designating which expenditures are to be treated as advertising. There is little consistency from company to company as to which costs are treated as advertising expenses as opposed to some other currently deductible item.

Compliance with the capitalization requirement would require a retooling of current accounting systems to segregate those expenditures that met the new definition. The segregation of advertising expenditures from other expenditures will ultimately be a question of fact, leading to increased conflict between taxpayers and the IRS and a nonproductive allocation of resources to deal with that conflict.

There is little agreement on what payments should constitute advertising. Direct payments to the media for advertising space and time could easily fall within a simplified definition of advertising. However, the line between direct advertising costs and other types of product marketing costs will be difficult to determine and even more difficult to comply with and enforce. For example, product marketing costs may include such disparate activities as introductory product discounts, promotional considerations, and sponsorship of public events, some of which may be more appropriately treated as reductions in sale price than individual expenditures.

V. CONCLUSION

Congress should reject any proposal that would limit the current deductibility of advertising expenditures. To require the capitalization and amortization of a portion of advertising would result in the mismeasurement of taxable income, limit the availability of information to consumers, and increase complexity.

Similar proposals have come before Congress in the past and wisely been rejected. This and future proposals should be rejected as well.

DON SUNDQUIST
7TH DISTRICT, TENNESSEE

COMMITTEE:
WAYS AND MEANS

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Testimony of Congressman Don Sundquist (R-TN)
Subcommittee on Select Revenue Measures
September 8, 1993

Mr. Chairman, my colleagues, I am very much opposed to this measure limiting the tax deductibility of advertising.

In the first place, this is discriminatory tax treatment. This provision assumes that advertising benefits carryover from year to year. There is no evidence whatever to support that assumption. I believe most people in business, especially those in small business as I was, will tell you that their advertising is intended to generate current sales and current revenue, and they believe that their advertising costs ought to remain a current expense for tax purposes.

But even if we buy into the assumption that advertising is undertaken for its carryover benefit, or that it produces such benefits, the fact is, we do not limit the tax deductions for other business expenses with carryover benefit. Why single out advertising?

Secondly, just what counts as "advertising", for purposes of this bill? Print and broadcast ads? Fliers left door-to-door? Promotions and discount offers? I don't think we want to get into that kind of regulatory micro-management.

Nor is this is good for the economy. Wharton Econometrics Forecasting Associates has projected that even a 20% advertising deduction disallowance would cost 185,000 jobs.

I want to remind my colleagues of the impact this would have on small community newspapers and on radio and television stations. Advertising revenue is what keeps those local media in business. Referring again to the Wharton Econometrics study, even a 20% loss in deductibility would triple the losses of the average AM radio station, while cutting profits at the average FM station by 100%. VHF television stations would see a 15-20% decline in their profits, while UHF stations would see an average loss of $100,000 per station.

This is not wise tax policy, nor is it good economics. I urge my colleagues to reject it, as we have done in the past.

FIDELITY FEDERAL BANK

ADMINISTRATIVE OFFICES
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P.O. BOX 1631
GLENDALE, CALIFORNIA 91209-1631
(818) 956-7100

September 1, 1993

Janice Mays, Esquire
Chief Counsel and Staff Director
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: September 8, 1993 Hearing
Subcommittee on Select Revenue Measures
Timing of Recognition of Financial Institution Points

Dear Ms. Mays:

Fidelity Federal Bank, FSB had previously requested an opportunity to present oral testimony in the September 8, 1993 Subcommittee Hearing. However, in deference to your request that persons and organizations having a common position make an effort to designate one spokesperson to represent them, Fidelity respectfully requests that you withdraw our request to testify individually and allow Fidelity to designate the representative for the Savings and Community Bankers of America, Michael Palko, to also represent Fidelity.

Fidelity strongly opposes any proposal which would accelerate the taxation points, or any other proposals which unfairly singles out the thrift industry in order to pay for tax benefits given to other industries.

Many years ago, tax policy favored the thrift industry in order to promote home ownership. However changes in tax policy in the eighties and nineties have caused the thrift industry to become a disfavored industry. This is evident in the significant disparity between the net book income and the taxable income of Fidelity's consolidated group for the past three years.

	(in millions)	
	Net Book Income	Taxable Income
1990	$ 2	$ 15
1991	2	71
1992	23	52
Total	$ 27	$ 128

Taxable Income in Excess of Book Income $ 111

The Bank's taxable income was five times higher than the Bank's book earnings over the same three-year period.

Under existing tax law, income is accelerated and material deductions are required to be deferred compared to the income and deductions recognized for SEC, GAAP, and Regulatory purposes. It appears inequitable on its face for one branch of the Treasury (the Office of Thrift Supervision) to use one measure of income for regulatory capital purposes, while another branch of Treasury (the Internal Revenue Service) uses such a significantly higher measure of income to determine taxes.

Any proposal which would tax points prior to the time they are contractually required to be paid is extremely unfair. In Fidelity's case an agreement to finance points which is signed by the borrower clarifies that points are received over the life of the loan, as principal payments are made. The Taxpayer opposes any proposal which would tax points in advance of the period required pursuant to Proposed Regulation Section 1.1273-1(d)(6)(i) (i.e., recognition as principal payments are made).

The Bank is sensitive to the enormous revenue needs of this country. However, Fidelity is already contributing far in excess of its fair share and simply cannot afford to pick up the tab for other industries.

Thank you for your consideration of this important matter.

Sincerely,

Kathleen Christianson

Kathleen A. Christianson
Senior Vice President Tax Director

KAC:se

STATEMENT OF KPMG PEAT MARWICK

TAX TREATMENT OF POINTS BY LENDERS

A legislative proposal currently under consideration by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means would "require a thrift institution to include in gross income points received with respect to single family mortgages when received. Alternatively, the proposal could be applied to all mortgage originators." We recommend that the Subcommittee reject this proposal. A requirement for mortgage lenders to include points in income upon receipt would create a tax accounting system for points that elevates form over substance, conflict with the underlying economic substance of mortgage lending transactions, defeat the purpose of the Congressionally-sanctioned OID rules, and perpetuate unending tax controversies between taxpayers and the Internal Revenue Service (the "Service"). In short, the enactment of such legislation would not represent sound tax policy.

After years of studying the proper tax accounting treatment of points paid in a lending transaction, the Treasury Department and the Service have concluded in proposed regulations that points paid incident to a lending transaction do not represent a current receipt of taxable income to the lender.[1] As measured by the lender's net economic position in a lending transaction, points paid incident to a lending transaction are properly regarded under the proposed regulations as a discount from the face amount of the loan and, therefore, are appropriately taxed in the same manner and at the same time as stated interest on the loan.

Background

Loan origination fees, or points, may be charged by mortgage lenders in loan origination and refinancing transactions. Points, if charged, are computed as a percentage of the face amount of the loan, each point being equal to one percent of the face amount of the loan. Generally, the interest rate on a residential mortgage loan that requires the payment of points is lower than the rate on a residential mortgage loan that does not require points.[2] In charging points, a lender reduces its prepayment or reinvestment risk because the effective yield on a loan which required the payment of points increases if the loan is repaid early. For tax purposes, points represent a charge for the use or forbearance of money and, consequently, are properly characterized as additional interest on the loan.

For many years, the proper tax accounting treatment of points by lenders was a major source of controversy between financial institutions and the Service. The Service historically permitted points to be recognized as earned over the life of a loan only in the case of a discounted loan, and required points to be included in income at the time of closing if the points were paid in cash with funds not originating with the lender ("fresh funds").

In Rev. Rul. 70-540,[3] the Service attempted to distinguish a situation in which points were discounted, and therefore treated as financed, from a situation in which the points were paid with fresh funds at closing. Far from clarifying the appropriate tax accounting treatment of points, however, Rev. Rul. 70-540 served to underscore the inherent ambiguity and circularity in this whole debate. It led to the realization by the Service and the Treasury that a payment of points at closing does not economically represent a receipt of income.

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[1] 57 Fed. Reg. 60750, 1993-3 I.R.B. 21.

[2] For example, a mortgage lender in the Washington, D.C. metropolitan area recently quoted interest rates for 30-year residential mortgages as either 6.75 percent plus one point or, alternatively, 7.125 percent and zero points.

[3] 1970-2 C.B. 101

As an illustration, assume a borrower needs $100,000 in principal and is charged two points, or $2,000, on the amount of principal borrowed. The parties can arrange the transaction in any one of the following forms:

1. The borrower can provide $2,000 in cash, pay the lender $2,000, and the lender can disburse $100,000 to the borrower;

2. The borrower can provide $-0- in cash, and the lender can disburse $98,000 to the borrower;

3. The borrower can provide $-0- in cash, and the lender can increase the face amount of the loan to $102,000 and disburse $100,000 to the seller.

Regardless of the form the parties agree to, the lender does not economically earn any income from the points at the time the loan is made. Only by giving significance to the circular flow of cash can one conclude that the lender should be treated as receiving income at the time the loan is made.

The Tax Court faced this dilemma in 1991. Based on the unique facts in a particular lender's case, it upheld the IRS's determination that the lender had received the points in cash and needed to include this "prepaid interest" in income at closing because the lender's loan documents did not contain an agreement to finance the points.[4] Given the economic equivalence of lending transactions in which points are charged, the Tax Court concluded that it could only discern whether points were financed or paid in cash by reference to the loan documents and the subjective intention of the parties. The Treasury and the Service ultimately retreated from this "form over substance" approach.

The 1992 Proposed OID Regulations

On December 22, 1992, the IRS issued a revised set of proposed regulations interpreting the original issue discount (OID) provisions found in sections 1271-1275 of the Internal Revenue Code. Generally, OID is the difference between a debt instrument's issue price and its stated redemption price at maturity. Section 1272 requires the inclusion of OID in a holder's income as it accrues without regard to the holder's method of accounting. The proposed regulations provide detailed rules for determining the issue price and stated redemption price at maturity for debt instruments.

Consistent with the principles of the OID rules, the revised regulations state that all cash payments incident to a lending transaction, other than charges for specific services provided (such as commitment fees and loan processing fees), are treated as a reduction in the issue price.[5] This treatment applies to all points either paid directly by a borrower or paid on behalf of the borrower by a third party such as the seller.

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[4] Bell Federal Savings and Loan Assn v. Commissioner, T.C.M. 1991-368. The court held that the points were in fact paid any time the borrower brought fresh funds to closing in an amount sufficient to cover the points and there was no agreement to finance the points.

[5] Prop. Treas. Reg. § 1.1273-2(j).

By charging points on a loan, a lender is treated as issuing the loan at a discount. As such, the points are deferred and recognized as income by the lender over the life of the loan, regardless of whether the points are paid in cash at the time of closing or whether the borrower is entitled to a deduction for the points under section 461(g)(2).[6] Generally, the lender must treat the discount as OID and take it into income based on the loan's yield to maturity over the life of the loan.[7] A loan's yield to maturity is generally the discount rate that, when applied to the stream of payments to be made on the loan, produces an amount equal to the loan's issue price.[8]

By disregarding the formalities in the transaction of the cash flow at closing, the 1992 regulations recognize the economic equivalency of the following transactions: (1) a transaction in which the lender disburses the gross loan amount in cash and the borrower simultaneously pays cash to the lender for the amount of points; and (2) a transaction in which the lender disburses the loan principal net of the points charged to the borrower and the borrower pays no cash. In either case, the lender has not economically received any income and should not be viewed as having received an advance payment. The points economically represent an adjustment to the stated interest on the loan and thus are properly taxed in a manner consistent with the stated interest on the loan.

Although the position ultimately adopted in the 1992 proposed OID regulations was reached only after extensive debate within the Service and the Treasury, the logic of the position and the sound tax policy it represents are difficult to question. Treating all points as discount that is recognized over the life of the loan as earned is consistent with Congress's intent in enacting the OID rules. As a fundamental premise, these rules disregard the formalities of a lending transaction in favor of an economically correct result. Thus, the OID rules prevent taxpayers from altering the character and timing of interest and principal payments and thus distorting income through the form of their transactions.

Even the proposed OID regulations issued in 1986 (superseded by the 1992 proposed OID regulations) recognized that cash payments generally should be treated as discount. The 1986 regulations, however, carved out exceptions for loans with de minimis OID and loans with points that were deductible by the borrower under section 461(g)(2). Most lending transactions involving points that are deductible by the borrower under section 461(g)(2) result in a de minimis amount of OID.

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[6] It should be noted that under the proposed OID regulations issued in 1986, which were withdrawn by the 1992 proposed regulations, upfront payments by a debt issuer (i.e., a borrower) were generally to be treated as discount and thus recognized under the constant yield method over the life of the debt, regardless of the holder's (i.e., the lender's) method of accounting, although the regulations did not apply this rule to de minimis OID and points that were deductible by the borrower under section 461(g)(2). Thus, the Service and the Treasury appeared to accept as a general proposition that points represent discount in the true economic sense and, hence, should be taxed in the same manner and at the same time as stated interest.

[7] Prop. Treas. Reg. §§ 1.1273-1 and 1.1272-1. If, however, the amount of OID on a debt instrument is de minimis (less than .0025 times the weighted average maturity of the loan, or less than .00167 times the number of complete years to maturity), then OID is recognized as the borrower makes principal payments.

[8] Prop. Treas. Reg. § 1.1272-1(b)(1)(i).

The 1992 proposed regulations, in contrast, properly recognize that the principles of OID are appropriately applied to all transactions involving a cash payment of points. The 1992 regulations provide a de minimis exception only as a rule of convenience, which permits, but does not require, a departure from the correct tax treatment.

The legislative proposal now under consideration by the Subcommittee is neither compelled by nor consistent with the historical tax treatment of advance payments. It has been asserted, for example, that the Service's position in the 1992 proposed OID regulations may be contrary to a substantial body of Supreme Court precedent concerning the taxation of advance payments.[9] Under this established body of case law, an accrual method taxpayer is required to include advance payments in income in the tax year of receipt. While the validity of these cases cannot be disputed, the proposition they represent does not apply in the case of cash payment of points incident to a lending transaction.

The Supreme Court trilogy requiring the current recognition of advance payments received applies only to the extent a taxpayer is determined to have received an advance payment of income. In a transaction involving a prepayment of cash by a service recipient, the service provider has undoubtedly realized an economic gain in the form of a nonrefundable payment for services to be provided in the future. In contrast, a lending transaction in which the points are included in the face amount of the loan (whether a net disbursement or an add-on loan) does not result in immediate economic gain to the lender. In fact, based on the lender's net cash position, the argument that the lender has received an advance payment is premised on the conclusion it seeks to prove. The current legislative proposal would not adequately account for this fundamental distinction.

The Service has also recognized, by administrative pronouncement and proposed regulation, that financial instruments requiring performance over a fixed period of time are fundamentally different from the types of service contracts in which the timing of performance is in the discretion of the purchaser.[10] The Service's position demonstrates that the principles applicable to advance payments are not violated by rules that properly measure the economic earning of income without regard to the timing of payments.

Treatment of the Borrower Under Section 461(g)(2)

By requiring the current taxation of all points that are determined to by paid by the borrower, the current proposal appears to be an attempt to create legislative symmetry between the treatment of the borrower and the lender. As an exception from the general rule of section 461(g)(1) requiring the deferral of a cash method borrower's deduction for prepaid interest, section 461(g)(2) permits a current deduction for points paid in connection with a loan for the purchase or improvement of a principal residence if the loan is secured by the residence. Beyond this one situation, however, symmetry would not exist if the proposal were enacted. For example, points paid on loans to refinance an existing loan, and points paid on loans whose proceeds are not used to acquire or improve a principal residence (e.g., a home equity loan to buy a car) are not currently deductible in the year of payment. As a result, the proposal would not create symmetrical treatment.

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[9] Schlude v. Commissioner, 372 U.S. 128 (1963); Automobile Club of Michigan v. Commissioner, 353 U.S. 180 (1957); American Autombile Association v. United States, 367 U.S. 687 (1961).

[10] Notice 89-21, 1989-1 C.B. 651; Prop. Treas. Reg. § 1.446-1(e)(3)(ii).

Moreover, an attempt to impose symmetrical treatment of points by the borrower and lender would lead to inappropriate taxation of the lender. Congress enacted section 461(g) to prevent abusive tax shelter transactions in which interest expense was front-loaded.[11] As indicated above in the discussion of the OID provisions, front-loading of interest is inconsistent with the economic accrual of income on debt instruments. Apparently, Congress enacted section 461(g)(2) as a matter of legislative grace to allow a deduction for prepaid interest (points) in residential lending transactions to facilitate the purchase of residential real estate. Section 461(g)(2) represents a decision by Congress to encourage home ownership by permitting a borrower to treat the payment of points in a manner that does not accord with the economic substance of the underlying mortgage lending transaction.

The public policy of providing tax incentives for home ownership, however, does not carry over to the lender's side of the transaction. Neither section 461(g)(2) nor its legislative history suggest that such a departure from the application of OID principles to the lender is appropriate. Furthermore, even if symmetry were desirable, the existence of an administrative safe harbor that applies to borrowers only would lead to the inappropriate characterization of transactions from the lender's perspective.[12] Thus, no tax policy would be served by requiring lenders to include points in income solely because some borrowers can deduct those points under section 461(g)(2).

Avoidance of Controversy

The enactment of legislation requiring the current taxation of points received would perpetuate a tax accounting system that elevates form over substance. To the extent the current taxation of points is based on a "payment received," such a system would cause the continuation of unending factual disputes between taxpayers and the IRS in almost every lending transaction. Because the application of the proposal would require that the form rather than the economic substance of each transaction govern the appropriate tax treatment, it would negate the sound and logical solution to the prior tax controversy reached by the Treasury and the Service in the 1992 proposed OID regulations. A rejection of the position adopted in these regulations would ensure the unequal treatment of economically identical transactions.

The proposal would foster an environment of endless controversy between taxpayers and the Service concerning whether points are financed or paid in cash. This determination is naturally fraught with uncertainty and depends on the subjective intention of the parties as reflected in the loan documents. Apart from the controversy, the proposal would undoubtedly inject an unnecessary amount of administrative complexity into the accounting for points. Mortgage lenders, for example, would be forced to apply a current inclusion method to certain transactions, while applying OID principles to other economically equivalent transactions.

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[11] See H.R. Rep. No. 658, 94th Cong. 1st Sess. 97 (1976), 1976-3 (Vol. 2) C.B. 789.

[12] Rev. Proc. 92-12, 1992-1 C.B. 663.

Conclusion

In summary, we recommend that the Subcommittee reject the proposal to subject lenders to current tax upon the receipt of points paid incident to mortgage lending transactions. These transactions should be taxed in accordance with their economic substance, consistent with the general intent of the OID rules, and to prevent unending disputes between taxpayers and the Service on examination.

TESTIMONY OF JAMES L. GOOD
NATIONAL ASSOCIATION OF WATER COMPANIES

The National Association of Water Companies (NAWC) is the trade association representing the nation's investor-owned water utilities. Its 360 members in 41 states provide safe, reliable drinking water to over 22 million Americans every day. We are pleased to submit this statement in support of the change in the recovery period for certain water utility property as contained in H.R. 846.

WATER UTILITIES OFFER A CHANGE IN DEPRECIATION ONLY AS A WAY TO PAY FOR THE COST OF CIAC REPEAL

Section (b) of H.R. 846 extends the depreciable life of certain water utility property from 20 to 25 years for property placed in service after enactment of H.R. 846. Depreciation of water utility property would also be determined using the straight-line method rather than the 150-percent declining balance method as required by present law. The Joint Committee on Taxation (JCT) has estimated this change will raise $140 million over five years.

After long, serious and contentious deliberations, our industry agreed to offer up this change in depreciation for water utility property, although it gores our own ox. We offer it only as a way to make up the revenue the JCT estimates will be lost with repeal of the tax on contributions in aid of construction (CIAC) to water and wastewater utilities found in section (a) of H.R. 846[1].

This offset is inseparable from the CIAC tax repeal and should be so treated by the Congress. We did not pour over the tax code in search of an esoteric loophole to close. Rather our industry is financing repeal with an increase in our own taxes. For some of our members, it represents real pain, but pain they are willing to bare if it means the CIAC tax will be repealed. We implore the Committee to respect this link and preserve it throughout the legislative process.

The revenue offset we offer is sufficient only to cover the cost of repealing the CIAC tax on water and wastewater utilities. But it is this revenue offset that makes the passage of H.R. 846 - and therefore repeal of the CIAC tax on water and wastewater utilities -possible. Repeal of the CIAC tax will aid our customers by ameliorating rapidly increasing drinking water costs; reduce the price of new housing by an average of $2000 nationwide; and protect public health by eliminating an incentive to the construction of small, poorly run water systems. These effects, as well as the operation of the CIAC tax itself, are explained in detail below.

THE TAX ON CONTRIBUTIONS IN AID OF CONSTRUCTION AND HOW IT WORKS

Water suppliers, like all utilities, are capital intensive industries. Historically, they have received the capital for the construction of a utility extension directly from the customer (typically a developer, although it can be a public school, a government agency or an individual homeowner). The customer contributes this property, or a cash equivalent, to the utility. In this way, utilities can eliminate the need to spread additional borrowing costs, in the form of rate increases, to the existing body of customers and protect them from business risk.

Prior to enactment of the Tax Reform Act of 1986, CIAC was not considered as gross [illegible] investor-owned utility and therefore was not subject to federal income tax. In addition, utilities could not earn on CIAC nor could they take tax depreciation or investment tax credits on CIAC.

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[1] In the short-term, adoption of H.R. 846 will net $32 million for the treasury. JCT has estimated repeal of the CIAC tax will cost $108 million over five years. Over the long-term, adoption of H.R. 846 will mean untold millions in additional tax revenues as repeal of the CIAC tax will no longer stifle the growth of a tax-paying industry.

The '86 Act repealed section 118(b) of the Internal Revenue Code and thus subjected CIAC to tax as gross income. Property received as a contribution is now eligible for any tax benefit, including tax depreciation, available under the Internal Revenue Code. However, even with this change in the tax code, water utilities and public utility commissions (PUCs) still do not consider CIAC as income, but rather capital and PUCs do not permit utilities to benefit from the CIAC.

EFFECT OF CIAC TAX ON CUSTOMERS AND HOUSING PRICES

Because of refunds and depreciation, over the life of a contributed asset the aggregate tax impact to the federal government is quite small. But because the customers of investor-owned water utilities pay the tax upfront, a disincentive to private capital investment is created which has far reaching effects.

Generally, PUCs permit utilities to receive a reimbursement for the taxes paid on the contribution plus the tax on this tax. This "gross-up" can add as much as 70 percent to the customer's cost of the contribution. In other words, a contribution of water mains valued at $100,000 would cost $170,000. The PUC directs these additional costs to be either passed-on upfront to the new customer, or through rates to the existing customer base.

When utilities pass on the tax (a tax which is grossed up), it has a detrimental effect on their business, housing costs and the environment, particularly where water utilities are concerned. If a gross-up is charged upfront, several things may occur:

a. the prospective customer may reduce the size of the project or abandon it completely because of the added cost, which has a negative impact on employment and the economy;

b. the cost will be passed on to new home buyers. The National Association of Home Builders has estimated the CIAC tax contributes as much as $2000 to the price of a new home. **The CIAC tax contributes to higher housing costs**;

c. the prospective customer will avoid the tax by:

1. setting up their own utility;

2. constructing individual wells and septic tanks - an alternative not as environmentally sound as community systems;

3. connect into a municipal system which does not pay taxes.

These last three alternatives are only practical for water and sewage service. In many cases, because of their much larger size, a gas or electric utility can pay for the facilities required by the new development making CIAC unnecessary. In addition, there seldom are alternatives to acquiring electric or gas from the local utility, since it is not economically feasible to develop an independent gas or electric supply. It is a relatively simple proposition to drill a well and establish an independent - frequently non-viable - water supply.

In some cases the CIAC tax is spread among existing customers, exactly what CIAC is intended to avoid. This can mean higher utility rates for customers of investor-owned water utilities compared to customers of municipal systems. Higher utility rates for the customers of investor-owned utilities can fuel cries for condemnation, to which investor-owned water utilities are particularly vulnerable. Under a condemnation, all tax revenues would be lost.

"Customers" are not just homes and businesses, they are any facility that needs water. This includes government facilities, churches, hospitals, prisons and schools. In such cases, the cost of the CIAC tax can sometimes be measured in non-economic terms.

One recent example of this is the experience of an elementary school in Pennsylvania. The state health department ordered the school off of its well after it was found to be contaminated. The school is in the franchise of one of our member companies and contracted with it for service. Because of the additional cost imposed on the school by the CIAC tax, it was forced to forego the purchase of textbooks.

ENVIRONMENTAL EFFECTS OF THE CIAC TAX

The best way to improve compliance with the Safe Drinking Water Act is to consolidate some of the nearly 60,000 water systems supplying drinking water. Another is to discourage the formation of new, small systems. Investor-owned water utilities are in a unique position to undertake consolidation through acquisitions and regional management. We are often asked, and sometimes forced, to do so by state health departments and PUCs.

Small water systems frequently pose problems for both EPA and the states. According to EPA, in fiscal year 1992, more than 90 percent of Safe Drinking Water Act violations were made by systems serving less than 3,300 individuals. Even more telling, 91 percent of systems with serious, frequent or persistent violations serve less than 3,300.

But the CIAC tax frustrates this environmental policy goal. As described above, the CIAC tax acts as an incentive to the construction of additional small systems in order to avoid the tax. It also encourages the installation of septic systems which can pose significant environmental threats to the local water supply. To make matters worse, a recent private letter ruling on the CIAC tax actually created a disincentive for the consolidation of water systems.

IRS letter ruling #9125009, released March 19, 1991, can make acquisitions of systems uneconomical. This letter ruling states the difference between the acquisition price and replacement price of a water system is CIAC! It makes many arm's length acquisitions uneconomical even when they are justified to protect the public health. And while a private letter ruling issued early this year, #9314023, narrowed the earlier ruling it still stands. The single most important step Congress can take to promote consolidation of water systems is repeal of the CIAC tax. With this one step, Congress will eliminate an incentive for the construction of new, small water systems and render the letter rulings moot.

H.R. 846

The NAWC strongly supports the enactment of H.R. 846 this year. H.R. 846 restores the historical treatment of CIAC to water and wastewater utilities. Repeal of the CIAC is also supported by the National Association of Home Builders and the National Association of Regulatory Utility Commissioners. H.R. 846 is sponsored by Congressmen Bob Matsui, Andy Jacobs, ten other members of the Committee and 77 members of the House.

There should be no controversy surrounding repeal of this tax. Water utilities will receive no tax benefit from repeal of the tax other than the time value of money. And as noted above, H.R. 846 will actually raise revenue for the federal government.

CONCLUSION

The NAWC urges the Subcommittee to adopt H.R. 846 and restore the historical exemption of contributions in aid of construction from gross income. Capital contributions should be treated as capital, not income. The tax on CIAC is not a tax on utilities, it is a tax on their customers. It increases the price of new homes, leads to the development of environmentally unsound water and sewage facilities and reduces the tax base for all levels of government.

What is more, the cost to repeal the CIAC tax will be borne by the same industry that will benefit from its repeal.

We are grateful for this opportunity to provide testimony to the Subcommittee on this vital subject and will gladly answer any questions its members may have.

Kieffer-Nolde
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Telephone (312) 337 5500
Toll Free 1 800 621 8314
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August 26, 1993

The Honorable Dan Rostenkowski
U.S. House of Representatives
District 5
Washington, DC 20515

Dear Representative Rostenkowski:

I was very surprised to learn that the House Ways and Means Subcommittee on Select Revenue Measures is considering a proposal to extend the depreciation schedule for certain graphic arts equipment from seven (7) to ten (10) years. This could have major negative economic impact on an industry that is still struggling from the recent recession.

The useful life of equipment in the graphic arts industry has shortened dramatically in recent years, as changing technologies force companies to reinvest in new equipment to stay competitive. While it used to be common to purchase a piece of equipment and keep it running for many years, today's environment has forced much more rapid change. By reducing my annual depreciation by almost 30 percent, this proposal will have a major impact on my decision to buy new equipment.

The graphic arts industry is the largest U.S. manufacturing industry in terms of number of establishments. Reducing the annual depreciation in this many firms will have a significant impact on industry employment.

I hope you will help prevent this short-sighted proposal from being considered by the Subcommittee. I hope to hear from you in the near future.

Sincerely,

Neal J. Schecter
Vice President/General Manager

NJS:sls

LASER
GRAPHICS INC.
24 Hillside Avenue, Hillside, Illinois 60162 (708) 449 • 2090
FAX: 708 • 449 • 5220 Modem: 708 • 449 • 7177

August 27, 1993

The Honorable Daniel Rostenkowski
House of Representatives
Washington, DC 20515

Dear Representative Rostenkowski:

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Sincerely,

LASER GRAPHICS, INC

Steve Giusti
President

DON SUNDQUIST
7TH DISTRICT TENNESSEE

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Testimony of Congressman Don Sundquist (R - TN)
Subcommittee on Select Revenue Measures
September 8, 1993

Mr. Chairman, my colleagues, I strongly oppose extending the depreciation period for printing equipment from seven years to ten years.

Printing is an industry I know something about; I was president of a printing firm before coming to Congress. Two factors drive competition -- price and quality. Profit margins are narrow, often in the neighborhood of three percent. Often, it is the edge gained from technological advances and new equipment that puts a printer into the black.

With computerization and digitalization, printing technology is undergoing revolutionary change. Many printers face the need to replace printing equipment within just five years. To force printers to depreciate over ten years equipment that may not be in service for even half that long is simply poor tax policy.

The commercial printing industry is an $80 billion industry. It is 42,000 companies employing more than 800,000 people. It is an industry often on the leading edge of the growth in high-tech jobs that we all support.

This proposed change in depreciation on printing equipment amounts to a punitive measure against a productive, growing industry. I urge my colleagues to reject it.

Techtron Imaging Centre
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Chicago Illinois 60611
Telephone (312) 644 4999
(800) 225 8 57
Fax (312) 346 4979

Waceusa

August 26, 1993

The Honorable Dan Rostenkowski
U.S. House of Representatives
District 5
Washington, DC 20515

Dear Representative Rostenkowski:

I was very surprised to learn that the House Ways and Means Subcommittee on Select Revenue Measures is considering a proposal to extend the depreciation schedule for certain graphic arts equipment from seven (7) to ten (10) years. This could have major negative economic impact on an industry that is still struggling from the recent recession.

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I hope you will help prevent this short-sighted proposal from being considered by the Subcommittee. I hope to hear from you in the near future.

Sincerely,

Walter C. Pabst

Walter C. Pabst
Vice President/Manufacturing

WCP:sls

Swavelle / Mill Creek
FABRICS
DIVISION OF ASSOCIATED TEXTILE CONVERTERS INC
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September 8, 1993

Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
US House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Ms. Mays:

Certain hearings have or will be held regarding certain miscellaneous tax proposals. I would like to comment on several:

Business travel deductions should not be limited to published coach fares. All fares should be deductible subject to normal substantiation requirements.

Travel expense deductions should be permitted for travel away from home in connection with holding or managing real property, regardless of whether it is the taxpayers principal business. The deduction should be limited by gross income from the activity.

Taxpayers should be required to include rental income with the same requirements of period of rental. Should the income be required to be included in income, then expenses for the period of rental should be deductible.

The deduction of wagering losses should continue to be deductible to the extent of gross income, not subject to an 80% limit.

Substantiation for meal and entertainment expenses should be required for all expenses in excess of $10, not for all expenses.

Should you have any questions, please feel free to contact me directly.

Very truly yours,

Jeffrey B. Kraut, CPA
Accounting Manager

CUSTOMS SCIENCE SERVICES, INC.
3506 FREDERICK PLACE • KENSINGTON, MARYLAND 20895-3405 • (301) 946-6052

Monday, August 23, 1993

Ms. Janice Mays
Chief Counsel & Staff Director
Committee on Ways & Means
1102 Longworth House Office Building
U.S. House of Representatives
Washington, DC 20515

Dear Ms. Mays:

This letter is in response to Rep. Rangel's announcement (Press Release No. 9) concerning "miscellaneous revenue issues." As a small business owner, I object to three of those proposals, none of which would generate enough money to even dent the deficit, but all of which would do serious harm to my business and, I assume, to thousands of others just like it.

The proposal to freeze next year's standard mileage rate for auto expense deductions at this year's level ignores the fact that the rate is **too small right now**, especially for businesses that cannot use public transportation ... believe me, we would if we could! The proposal ignores inflation and penalizes companies that have to "get-up-and-go" to get business and generate jobs.

Limiting the business mileage deduction for trips beginning at home to mileage in excess of 10 miles would **destroy** the entire mileage deduction for home-based businesses. This proposal would take money from the businesses that need it most, and the revenue generated would not even show up on your screen ... not even a blip. This is a truly lousy proposal, and should be "deducted."

Finally, the proposal to deny deductions for travel expenses in excess of the coach fare is OK **only** if the "coach fare" is the ordinary, unrestricted "buy-it-and-fly-it" coach fare. Taxpayers should not be subsidizing first class travel (which is obviously the aim of the proposal) but business travellers should not have to fly triangles at 2 a.m. Sunday to deduct the expense either.

Thank you for your consideration of these comments.

Very truly yours,

Roger J. Crain

Roger J. Crain, President
Customs Science Services, Inc.

Coopers
&Lybrand

certified public accountants

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WRITTEN STATEMENT OF COOPERS & LYBRAND REGARDING THE 14-DAY RULE ON RENTAL OF A RESIDENCE BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES OF THE COMMITTEE ON WAYS & MEANS

SEPTEMBER 21, 1993

Coopers & Lybrand, on behalf of itself and its clients, would like to express concern about the proposal to repeal the special tax exclusion for income received from the rental of a residence for less than 15 days if the taxpayer forgoes related deductions (IRC §280A(g)). The rationale for the present law rule is to simplify tax filings for this class of taxpayers who otherwise are likely to have uncomplicated tax filing requirements.

The proposed change would be a major reversal of the simplification policy that the Committee on Ways and Means has undertaken in recent years.

- **It would subject taxpayers who rent out all or a portion of their homes for less than two weeks to the inordinately complex maze of rules which governs the tax treatment of mixed-use residences.**

- **For the large number of average taxpayers who may rent their homes for a special community event on a one-time or annual basis, the additional tax complexity would be inordinate, particularly relative to any additional tax collected.**

- **To the extent that the added complexity will discourage homeowners from renting their homes, it is likely to disrupt the annual events (both commercial and charitable) that take place in those communities which lack the hotel capacity for the event.**

In assessing this additional complexity, it is important to consider the burdensome amount of tax compliance activity that the affected taxpayers would be required to undertake for mixed-use residences. In addition to time spent just reading and absorbing the requirements, records must be gathered to document the annual costs for utilities, insurance, and other deductible expenses; basis must be established and depreciation calculated for Form 4562, Depreciation and Amortization Schedule; and Schedule E must be completed. The IRS estimates that complying with the mixed-use rules requires taxpayers to spend an average of **36 hours** on recordkeeping, **7 hours** on filing Form 4562 and **6 hours** on Schedule E reporting. In subsequent years, the added burden would be somewhat less, but nevertheless significant. In any year that the home is sold, additional complexity would be involved in calculating gain and applying the rollover rules.

Coopers & Lybrand is a member firm of Coopers & Lybrand (International)

The following is an explanation of some of the rules that the proposed change would extend to more taxpayers, as they apply to taxpayers who rent their principal residences; similar but slightly different rules would apply to vacation home rentals.

The rules to determine the deductible portion of rental expenses are intricate. A taxpayer renting a portion of a principal residence is allowed to deduct expenses to the extent of rental income. However, the rules provide a specific order to determine which type of expenses will be deductible. Mortgage interest and taxes are deducted first, then other operating expenses (e.g., advertising, utilities, insurance), then depreciation. If the rental portion of interest and taxes is greater than the rental income, the other types of expenses cannot be deducted. These rules are designed to strictly limit a taxpayer's deductions for expenses related to the rental of his residence such that there is no loss on the rental activity.

In addition, other rules must be applied to determine the appropriate amount of an expense which is allocable to the rental use of the house. For example, if an expense relates to both the personal and rental areas of the house, such as mortgage interest or heat for the entire house, the expense must be divided between rental and personal use; usually this allocation is based on the square footage of the house. Once the expense amount for the rental area is calculated, the taxpayer must further allocate that expense based on the number of days the area is used for rental versus personal purposes.

For example, assume a taxpayer rents a 200 sq. ft. room of his 1800 sq. ft. house for 7 days and has an annual utility bill of $1000. To determine the deductible portion of the utility bill, the total yearly expense first is multiplied by 200 sq. ft./1800 sq. ft. to determine how much of the total expense relates to the rented bedroom; this result is multiplied by 7/365 to determine the amount related to the rental days. This final product is the amount that may be deductible subject to the income limitation and ordering rules.

This allocation process must be done for all out-of-pocket expenses related to the rental activity including interest, taxes, utilities, insurance and maintenance costs.

Depreciation calculation can be difficult. Once the taxpayer has determined the amount of interest, taxes and other operating expenses which are deductible, the taxpayer must then calculate the amount of depreciation for the part of the house which is rented.

The first step in this process is determining the taxpayer's basis in the house. This can be a formidable project for many taxpayers. The beginning point for this determination is generally the purchase price of the property plus certain closing costs. This cost must be divided between the building and the land. The initial building cost is then increased by such costs as major repairs and improvements and decreased by any costs that represent a return of the taxpayer's cost such as insurance reimbursements due to a casualty or theft loss. This basis calculation is further complicated if the taxpayer has deferred recognition of gain from a previous principal residence. Taxpayers may need to access records that are 30, 40 or even 50 years old to determine their basis.

After determining the basis in the house, the taxpayer must determine the portion of that basis related to the rental use of the house. Finally, the amount of the depreciation can be calculated - both for regular tax and alternative minimum tax purposes - using the different periods and methods allowed by each under the applicable tax law. This is not as straightforward as it may sound. A 1984 Revenue Ruling held that when a house was converted to rental use, the applicable cost recovery rules were those in affect at the time of the home's purchase, not the date of conversion. If this rule is held to still apply, taxpayers could be faced with selecting the correct rules from several sets of depreciation rules applicable to past years.

Further, it should be noted that, upon future sale or replacement of the home, when the taxpayer computes the house's basis, determining the amount of gain on sale and any possible gain deferral will also be more complex.

Tax return reporting requirements. After determining the amount of gross rental income received and calculating the deductible amount of all of the expenses, the taxpayer should be ready to complete the appropriate tax forms. The rental income and the deductible expenses for rental use are reported on Schedule E. This includes the rental use portion of mortgage interest and taxes. The remaining "personal" portion of mortgage interest and taxes is reported on Schedule A. If total rental expenses are more than the rental income, the excess amount cannot be deducted. However, the extra rental expenses can be carried forward and used in future years to reduce rental income if there are not enough expenses in those years to totally offset the rental income. To take advantage of this carry-forward provision, the taxpayer must keep records of these expenses year to year on an ongoing basis. In addition, the taxpayer must complete Form 4562, at least for the first year, to report any allowed depreciation.

In summary, the rules governing the tax treatment of income and expenses relating to the rental of a portion of a taxpayer's principal residence are very complicated. Most taxpayers will find it difficult and time consuming to negotiate this maze of rules without the help of a tax preparation professional. For some annual regional events in rural communities, the available commercial rooms are insufficient to handle the volume of people who attend. Our clients are concerned that many taxpayers will simply choose not to rent their homes for special events in their communities, and the consequences to these local economies and affected businesses could be severe.

We suggest that the legislative proposal to repeal the special tax exclusion for income received from a 14-day (or less) rental of a residence be dropped as adding additional complexity to the tax law that is simply not warranted, either by the small additional revenue to be gained or by the policy result.

TESTIMONY OF MR. DAVID BELDING, CHAIRMAN, NEVADA RESORT ASSOCIATION, CONCERNING THE TAX DEDUCTIBILITY OF GAMING LOSSES

WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES

CONGRESSMAN CHARLES RANGEL, CHAIRMAN

SEPTEMBER 8, 1993

I wish to take this opportunity to record my opposition to a proposal suggested to this Committee recommending that the deduction for wagering losses be limited to 80 percent of the amount otherwise deductible.

This proposal is not only poor tax policy, but is also unfair to the American taxpayer, as well as the gaming industry and the companies which comprise the Nevada Resort Association. The Hotel/Casinos which comprise the Nevada Resort Association will make a major contribution to efforts to reduce the nation's federal budget deficit through changes in the tax laws enacted as part of the 1993 Budget Reconciliation Act. Because of these new tax laws, they will not only pay higher corporate taxes, but the tourist industry, their economic mainstay, will suffer because of higher fuel taxes and the reduced value of tax deductions for business travel, meals and entertainment expenses. The members of my industry accepted these changes because of the dire need to gain control of our federal deficit for the good of all Americans, and because the burden will be shared by all sectors of our economy.

However, with the ink hardly dry on the Reconciliation Act, some members of Congress are proposing another round of tax increases. This time the new taxes are not to go for some overwhelming national need. Instead, tax increases are proposed for some segments of the economy in order to pay for tax breaks for other more favored taxpayers. The motive here is not sound tax policy. Nor is there justification that such changes are needed for the greater good of the country. No, this is strictly a case of robbing Peter to pay Paul; of pitting one segment of the economy against another, in order to provide favored treatment to a selected group of taxpayers.

Not only are the tax increases being proposed in this hearing, and again on September 14th unfair, but there is, as I noted earlier, no sound tax policy behind the proposal to limit the deductibility of gaming losses. Joseph A. Pechman, a senior tax policy analyst with the Brookings Institute for many years, defines individual tax deductions by breaking them down into several categories. For example, he points out that Congress has deemed it good tax policy to allow deductions for large, unusual, and necessary personal expenditures by American families such as medical costs and uninsured losses resulting from thefts, fires, storms and other casualties. Further, Congress has provided deductions for contributions to religious, educational, and other nonprofit organizations. Congress also permits federal tax deductions for income and property tax payments made to state and local governments.

Economists may argue over the relative merits of these types of tax deductions, but Professor Pechman finds that few, if any, question the legitimacy of the remaining class of deductions -- those that make allowances for the costs and losses directly involved in obtaining income. These offsets against gross income have been part of the tax code almost from its inception. To begin limiting the value of these offsets, strikes at the very core of rationality and fairness underlying our system of income taxes. Where is the rationality in proposing to limit the deduction for gaming losses and not limiting the writeoff of losses in purchasing securities? Why not then eliminate the writeoff of losses from the purchase of investment property, or any other direct cost of producing income? Such an approach to income taxes makes no sense.

I want to note at this point that the value of gaming loss deductions are already limited under current law. Taxpayers cannot use gaming losses to create offsets against other types of income. Loss deductions are only allowed up to the level of gross gaming winnings. Any losses exceeding the amount of gross winnings are not permitted as deductions against total income. To propose placing further limits on the value of gaming loss deductions, permitting them against only the first 80 percent of gross gaming winnings, creates a further unfair tax burden for the taxpayer with gaming losses.

To pursue a policy of arbitrarily choosing who is to pay more in order to provide tax benefits to other more favored groups, without basing tax decisions on sound tax policy, is not only unfair; it is folly. Worst of all, it makes some Americans into second class citizens, who are for some unknown reason, not due the same tax treatment by their government as their peers. This is folly and I hope that the Committee and Congress will reject this ill-conceived proposal.

Congress should reject this cynical and selfish approach to tax legislation. This is not what the American people expect from their government. There is no mandate for this kind of parochial game playing. We have serious national problems, not the least of which is health care reform, that deserve the full attention of Congress.

SeaWest

September 7, 1993

Janice Mays
Chief Counsel & Staff Director
Committee on Ways & Means
US House of Representatives
Washington, D.C. 20515

RE: Current hearings on miscellaneous tax proposals

Dear Ms. Mays:

According to a tax service, a proposal is being put forth to deny business deduction for travel expenses in excess of the amount of coach fare if coach passage is available for the trip.

I am both a CPA who has prepared business and personal returns, and work in a small business where a lot of flying is involved. I object to this proposal on the following grounds:

1. We travel quite a bit to Europe and Japan, for export purposes. The flights are long, you change time zones by 8+ hours, and you need to be able to function when you arrive. Coach is not conducive to this. Also, you can't get any work done in coach, because it is so cramped.

2. A lot of travel is by contractors, being paid their way by the client. A condition of travel could be non-coach class. This would penalize the hiring company. Or alternatively, it could force the contractor to fly coach when there are substantive reasons that this would not be beneficial.

3. I think the airlines will lose a lot of money, because much of first class is business. They will be forced to increase coach fare, penalizing those who are not in your gunsights.

4. The airlines pay tax (I hope) on the first class fare or the coach fare. The business deduction by the taxpayer is offset whether they pay first or coach, so there is no revenue benefit, only harm as described in #3, above.

5. I am 6'7". Take it from me, coach is not much fun for some people. 10 hours to Denmark? Hopefully, the Clinton health plan will pay for knee surgery.

6. This is a recordkeeping nightmare, as so many of these miscellaneous provisions often are.

Give us a break and take this out of the bill.

Sincerely,

SeaWest Industries, Inc.

Thomas G. Farnham

Thomas G. Farnham
Senior Vice President, Administration

Harry Reid

STATEMENT BY SENATOR HARRY REID
12 PERCENT SEVERANCE TAX ON HARDROCK MINERALS
September 8, 1993

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I would like to express my opposition to the 12 percent severance tax that has been suggested by Representative Stark and is one of the topics before this committee today. As I understand it, this is an informal proposal and I recognize that some of the specifics of how this tax might be assessed have not been made public. My strong opposition may, therefore, appear premature, but let me assure you that it is grounded in nearly a decade of experience with this particular issue.

Let me start by making it perfectly clear that I do not oppose a royalty on hardrock minerals. In fact, I cosponsored a bill in the Senate that calls for the first royalty ever on hardrock minerals in the history of this country. I oppose this particular severance tax, for two reasons: first, it lacks a sound economic foundation; and second, the proposal to impose a tax outside comprehensive mining law reform undermines a tenuous, but so far successful, strategy to finally achieve success in this decade-old fight.

We have never in the history of our country had a federal severance tax or a royalty of any kind on hardrock minerals. We have royalties on other extractive resources, and I suspect that the 12 percent severance tax being put forth today is based on these existing examples. But, if this is the case, the logic is flawed. To suggest that the royalties charged for oil and gas or coal can serve as archetypes for a severance tax on hardrock minerals demonstrates naivete for the applicable economic and technical forces. The economics, geology, engineering and beneficiation requirements that apply to hardrock minerals are a world apart from those that apply to coal, oil and gas. With no experience to draw upon, all we can do is guess what the impact will be-- and guess we have. We have as many predictions as we have had economists looking into this issue. The impacts are orders of magnitude apart.

Should this committee decide to proceed with this proposal, you will experience a replay of the debate that has occurred in the authorizing committees for the past decade regarding which economic prediction is right and which is wrong. If there is one indisputable fact, it is that the impacts on the hardrock industry and the Western economy are unknown--but would be significant. Let us be mindful of just what these impacts are. They are not just numbers on some balance sheet, they are jobs and families and communities. We do not have experience or hard data, and we have widely dissenting viewpoints. Yet we hold thousands, perhaps tens of thousands, of jobs in the balance.

Americans deserve a fair return for the hardrock minerals taken from the public lands. It is equally important, however, to recognize the contribution the mining industry makes to the economy of this nation and the significant role mineral materials play in maintaining the standard of living of every American. As we in Congress work to develop a fair tax, we must also work to maintain the viability of the mining industry.

An excessive tax could easily damage the industry beyond its ability to recover. Why? Because the mining industry is already on the ropes. Prices have fallen drastically during the past decade. For example, the price of gold has fallen from a high of $446 per ounce in 1987 to the current price of about $350 per ounce--a 22% decrease. The return on investment for the gold mining industry has fallen from 14.5% at the peak to its current 3.5% and this trend is indicative of the entire mining industry. The net profit margin for all U.S. mining was 1.58% in 1991. Since 1990, total employment in the industry has been decreasing by slightly over 4% per year--14,000 jobs have been lost since 1990.

One has to question the wisdom of imposing a 12 percent tax on the mining industry already suffering in these tough economic times. A 12 percent tax rate far exceeds the average profit margin for the mining industry. In other words, this proposal suggests that the U.S. Government should take all the profit most mining companies make--and more. This proposal will not be a revenue generator because it will put most mining companies out of business. In fact, it will be just the opposite, a drain on the U.S. Treasury as we add thousands to the unemployment lines and forego the corporate and individual income taxes that these working Americans pay.

In addition to being excessive, this tax is unfair. It is unfair because it proposes to collect on value added by private investment after the minerals have passed from public ownership. The public deserved fair compensation for the value of the minerals as they exist in the ground. But minerals must be discovered, extracted, refined and shipped in order to achieve this value. Each step in the process adds to the value of the mineral, but each requires private investment. The public has no stake in these investments which account for the vast majority of the ultimate market value. To demand compensation for minerals whose value was achieved largely through private investment is not fair.

The Senate has already passed a bill that calls for a royalty on net proceeds assessed at the 'mouth of the mine'. This royalty is designed to remove private investment from the assessment of value. The initial royalty rate specified in the bill is two percent. This rate is purposely conservative to mitigate any drastic impact to the industry as we proceed into this previously unexplored frontier. The bill establishes a special commission to review and recommend changes in this rate as hard data becomes available. The rate can always be increased if the commission determines that it is too low, but starting too high, such as 12 percent on gross proceeds, could inflict irreversible damage to the industry and to the economy in the West.

I have seen no evidence that these economic circumstances have received any consideration in this proposal. To impose a tax without a objective economic analysis is to experiment in a reckless manner with peoples' lives. I have and will continue to fight any initiative that does so. As if this were not reason enough to oppose this particular tax, the proposal itself also undermines the bipartisan effort that is moving forward in this Congress to achieve comprehensive mining law reform.

In every Congress for nearly a decade, mining law reform has been tried. Without exception, the reform bills have died in the extraordinary stubborn stalemate propagated by highly polarized viewpoints. Year after year, we in Congress fight the mining law reform battle and have nothing but scars to show for it. Until April of this year, mining law reform in the 103rd Congress appeared destined for its traditional fate.

This year, Senator Johnston, the Chairman of the Energy and Natural Resources Committee, stepped forward and offered his leadership to break the gridlock and move this issue to resolution. Senator Johnston proposed that a comprehensive reform bill be written in conference, providing that the conferees be granted the greatest possible latitude to negotiate a solution. This strategy has proven successful for the Senator from Louisiana in the past on issues where the opposing sides were unable to find middle ground on their own.

There is considerable risk in this strategy. Those on either side of this issue are required to put their trust in the negotiating process. But the risk is equal to both sides, and no action promises perpetual gridlock. So with cautious optimism, both sides agreed to give Senator Johnston's strategy a chance.

On May 25 of this year the first phase of this strategy was executed. S.775, a mining law reform bill introduced by Senator Craig, passed the Senate on a unanimous consent agreement. With the agreement, Congress advanced one step closer to reform than it has ever been previously.

That progress is now threatened by this proposal. Instead of allowing the negotiations to occur on comprehensive reform, this proposal will remove a key issue from the negotiating table to be dealt with separately and in isolation from comprehensive reform. In my view, this breaches the trust that underpins the Chairman's strategy.

I am committed to providing a fair return to the public for its share of the value of minerals removed from the public lands as a part of comprehensive reform. But there is no compelling need to deal with this issue outside the comprehensive reform initiative and, in so doing, jeopardize the already fragile pact forged by Senator Johnston.

The decision before this committee today is not whether a 12 percent tax is just or economically sound at this point in time. The real issue is whether you support the Chairman of the authorizing committee in the Senate and his strategy to accomplish comprehensive reform in this Congress. Support for this proposal is a vote against comprehensive mining law reform. It is a vote for gridlock and I strongly oppose further consideration of it for this reason.

The subject of a hardrock royalty or a severance tax, is one of the most important issues associated with mining law reform. A fair and economically sound royalty is critical to wise and effective mining law reform, but it is only part of comprehensive reform. Equal scrutiny must be brought to bear on other reform issues, especially permitting, environmental protection and reclamation. I urge the Committee table this proposal and allow the authorizing committees to complete the effort already underway to achieve comprehensive reform.

Thank you Mr. Chairman.

Testimony of
The Center for International Environmental Law
Before the Subcommittee on Select Revenue Measures
Committee on Ways & Means
United States House of Representatives
September 8, 1993

Mr. Chairman and Members of the Committee, thank you for the opportunity to appear before you. Briefly, the Center for International Environmental Law (CIEL) is a not-for-profit, public interest environmental law firm that focuses on international and comparative legal issues. Since the outset of the trade and environment debate, CIEL has been among the leading environmental groups working to resolve trade and environment issues. Our most recent effort, Trade and Environment: Law, Economics and Policy, is now available from Island Press. CIEL's Trade and Environment Program focuses on the inter-relationships between and among, environmental protection, international trade and competitiveness concerns.

CIEL's Trade and Environment Program strives to promote what we call competitive sustainability—the use of legal and market mechanisms to create incentives for environmentally sound economic activities on open global markets, and disincentives for economic activities that are environmentally unsound. Competitive sustainability attempts first to level the playing field to allow environmentally sound companies to compete on equal terms with their less aware competitors. Second, competitive sustainability seeks to, wherever possible provide competitive advantages to the cleanest economic actors as an incentive to encourage others to follow in their footsteps. As CIEL has written elsewhere:

> "Competitive sustainability" defines a mechanism for realizing sustainable development through the "upward harmonization" of domestic and international environmental standards, using competitive forces to create a level playing field for commerce at consistently higher levels of environmental and social protections that reward the cleanest and most efficient economic actors for their efforts. The goal here is not to overburden economic activities, but to put them to work for the environment. By focusing economic activities, through incentives and disincentives, in directions that yield economic and environmental benefits, these activities can become engines to drive standards of living—broadly defined to include economic, environmental, social, and health stability and security—upwards.[1]

Today, we are here to testify before you in support of the concept of leveling the environmental playing field, in this case by imposing a tax on imported gasoline approximately equalling the embedded costs differential of environmental compliance costs as advocated by Robert H. Campbell, President, CEO and Chairman of Sun Company, Inc. in his testimony on behalf of the Independent Refiners Coalition before this Subcommittee. As discussed below, CIEL supports this proposal, not on the basis of any economic interest, but rather on its environmental and trade policy merits.

U.S. companies operate under the most stringent environmental regulatory systems rigorously enforced anywhere around the world. Further, an increasing number of U.S. companies are taking up the environmental challenge and striving not only to comply with U.S. laws, but to go "beyond compliance." Surely not all companies have adopted and implemented this strategy, and some may question the motives of those that have, however, the simple fact remains: U.S.

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[1] Robert F. Housman & Durwood J. Zaelke, Making Trade and Environmental Policies Mutually Reinforcing: Forging Competitive Sustainability, 23 Envtl. L. 545, 546 (1993) (citations omitted).

companies are among the most environmentally sound market actors at work today.[2] Companies that are striving to become environmentally sound actors are to be commended and rewarded. Unfortunately, while they may be commended, global markets do not as yet reward them.

While U.S. companies are striving to meet or exceed the requirements of our domestic environmental laws, many other nations lack proper environmental laws, or if they have proper laws, the enforcement of these laws is often non-existent. While U.S. companies "pay" at least some component of the environmental costs of their operations, other nations' industries obtain the benefits of resources free from the costs of environmental compliance. Essentially, the air, soil and water our companies pay for through the dictates of the Clean Air Act Amendments, the Federal Water Pollution Control Act, the Resource Conservation and Recovery Act and the Comprehensive Environmental Response, Compensation and Liability Act, and other federal, state and local laws, are free to their competitors.

Although in many instances environmental laws and regulations can make companies more efficient and can actually aid the long-term competitive posture, this is not always the case. Even where it is the case many companies are not fully aware of these advantages. While environmental laws can increase the efficiency with which regulated companies use raw materials or resources, if a regulated company's competitors do not have to pay for the use of these same environmental materials or resources, added efficiencies cease to be the issue. Even the most efficient industry that pays its environmental costs of resource usage will always incur a cost greater than their unregulated competitors who pay nothing for the use of the same environmental resources; nothing is cheaper than free.

Pervasive environmental compliance cost differentials put environmentally aware U.S. companies at a competitive disadvantage vis-a-vis their foreign competitors. Simply put, where our ever-developing environmental commitment is not being met by our trading partners the result is a playing field that favors dirty industries and hamstrings environmentally sound actors. This competitiveness problem manifests itself on a range of levels of differing severity. At the low end of this range some companies find that environmental regulatory regime differences have little or no effect on their competitiveness. At the high or more severe end, other companies, particularly companies in heavily regulated industries, find that the differentials in environmental costs are so substantial that they can no longer afford to operate in the United States; they either close down altogether, or they ship their operations abroad.

The loss of domestic industries because of environmental competitive disadvantages, or even the perception that such losses are occurring, has a number of serious consequences. First and foremost, in the aggregate, global industries become dirtier as opposed to cleaner; cleaner U.S. operations close and dirtier foreign operations replace them, resulting in a net environmental loss. Second, the loss of each U.S. industry undermines the U.S.'s ability to achieve environmental excellence. With every U.S. job lost over, or even perceived to be lost over, an environmental issue the political wherewithal to adopt and enforce the necessary environmental protections diminishes as well. Third, the loss of industries to environmental protections eliminates to a large extent the incentives on other industries to be more environmentally sound. The loss of industries exacerbates the often false perception that environmental compliance and excellence is bad for business causing some industries to shy away from, or even fight against, environmental initiatives.

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[2] For example, the Sun Company recently became the first Fortune 500 Company to adopt the rigorous and voluntary requirements of the CERES, or Valdez, Principles. See also J. Andy Smith, III, The CERES Principles: A Voluntary Code for Corporate Environmental Responsibility, 18 Yale J. Int'l L. 307 (1993) (discussing requirements of the CERES Principles).

Based upon the information now before us, it appears that the U.S. petroleum refining industry now faces precisely the environmental competitive disadvantages discussed above. A recent study prepared for the Department of Energy estimates that the U.S. refining industry will have to invest $51 billion between 1991 and 2010 to meet the requirements of our domestic environmental laws.[3] Translated into terms we all as consumers can understand, U.S. refined gasoline will carry an estimated additional environmental cost of $.05 per gallon in 1994, and $.13 in 2000.[4] When you consider that the profit margin on a gallon of domestically produced gasoline is roughly a penny these cost increases are more than substantial. At the same time, it is CIEL's experience from its work around the globe, that many, if not most, other nations fail to effectively enforce their environmental laws, or lack such laws altogether. The effects of these differential environmental compliance costs are apparently already being felt within the industry, as increasing numbers of U.S. refiners are closing down or moving overseas.

If you were to apply CIEL's framework for competitive sustainability to the situation at hand the resulting policy would look substantially like the Independent Refiners Coalition proposal now before you. While we support the general framework of the Independent Refiners Coalition proposal we believe that their proposal can, no pun intended, also be refined. For example, to provide foreign countries with an incentive to raise their environmental standards, other countries should be allowed to petition and prove that their environmental compliance program for petroleum refining is comparable to that of the United States, thereby removing the tax from their products. Similarly, to provide foreign refiners with an incentive to voluntarily enhance their environmental performance, these refiners should also be accorded a similar opportunity to petition to have the tax not applied to them. Of course, establishing comparability will prove challenging, and we should scrutinize carefully the comparability claims of our trading partners. Evidence of comparability must be presented to demonstrate not only the existence of a comparable regime of environmental laws, but also enforcement and compliance with the underlying framework of laws. Other improvements could be made in the proposal by elaborating on how the monies obtained shall be used. To assist developing countries in meeting the added burdens of this tax, some component of these monies should be provided in the form of technology cooperation and technical assistance to help them meet this challenge.

A "refined" version of the tax proposed by the Independent Refiners Coalition would also have a very important effect on the ongoing efforts to reconcile trade and environment policies. This tax would send a signal to our trading partners that the U.S. is serious about resolving trade and environmental issues in a timely and balanced fashion. Despite their lip service to environmental issues, our trading partners have been uniformly reticent to improve the linkages between trade and environment. In virtually every trade and environment institution, the United States stands as the strongest, and often solitary, environmental voice. After almost three years of effort, we are virtually no farther today in the trade and environment debate than we were at the outset. The U.S. continues to be the only country advocating public participation in trade institutions. The U.S. continues to be the only country that advocates the sovereign right of a nation to use market access to prevent the destruction of the global commons. In fact, the reason the petroleum tax being discussed here today is couched in the terms of national security is because the international trade rules and institutions, as well as our trading partners, refuse to recognize that the failure to maintain the most basic environmental controls amounts to a pollution or sin subsidy to the industries in question.[5] Surely other nations are willing to discuss these issues, however, after three years of discussion the time for discussion has long passed; the time for reconciliation is at hand. The tax proposed by the Independent Petroleum Refiners is a first step towards forcing our trading partners to deal with trade and environment in a serious and good faith manner.[6]

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[3] NPC, U.S. Petroleum Refining, Aug. 2, 1993 (Draft), p. 1.I-1.

[4] *Id*.

The trade and environment debate has lingered too long without an imperative for action. To paraphrase Henry Kissinger, a decision avoided is more times than not a crisis created. It is in the economic and environmental interests of the United States to avoid this crisis. The tax proposal put forward by the Independent Petroleum Refiners is not a substitute for the needed democratic and environmental reforms to trade rules and institutions, however, as fire under all our feet, it could be a first step in this direction. Thank you.

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[5] It is obviously within the U.S.'s long-term environmental, military, and economic security interests to reduce its dependence on nonrenewable energy resources. To the unfortunate extent, however, that we remain reliant on fossil fuels our goals should be to conserve these resources to the greatest degree possible, and to ensure that the production of fuels from these resources is conducted in the most environmentally sound manner possible. While CIEL does not today pass on the national security issues raised here, CIEL does believe that the environmental justifications for this tax are meritorious in and of themselves and should be recognized as such.

[6] Unilateral action forcing initiatives are common place methods of forcing changes to the international trading system. See Robert E. Hudec, Thinking About the New Section 301: Beyond Good and Evil, in Aggressive Unilateralism: America's 301 Trade Policy and the World Trading System 113 (Jagdish Bhagwatti & Hugh T. Patrick eds., 1990).

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URVAN R. STERNFELS
President

September 22, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

The following comments are filed regarding the member amendment of Rep. Mike Andrews discussed during the September 8, 1993 hearing of the Subcommittee on Select Revenue Measures. Rep. Andrews's proposal would increase the tariff on imported crude oil by 15 cents per barrel and refined petroleum products by 1 cent per gallon. The National Petroleum Refiners Association (NPRA) is filing these comments in opposition to the Andrews amendment.

NPRA represents virtually all domestic petroleum refiners and petrochemical manufacturers using processes similar to refiners. NPRA's members, which include not only the larger companies, but many small and independent companies as well, support government policies to enhance domestic production, petroleum refining capacity and petrochemical manufacture, but which do not raise energy and feedstock costs.

Rep. Andrews's proposal would cause an increase in the cost of crude oil, which is the feedstock for the refining industry. In addition, it would cause an increase in the cost of feedstocks required by the petrochemical industry. These increased costs would apply only to domestic participants in an international industry, and would put them at a competitive disadvantage vis-a-vis foreign refiners and petrochemical manufacturers. New tariff burdens would result in higher raw material costs for not just foreign origin material, but for domestic raw materials as well. This could lead to plants being shut down, loss of jobs, and reduced investment in U.S. industries which rely on petroleum.

According to the Department of Energy's 1987 report entitled Energy Security, an increased tariff on crude oil and refined products (which is equivalent to an oil import fee) would reduce economic growth, increase inflation and reduce U.S. competitiveness in both foreign and domestic markets. Such a tariff increase would encourage capital investment in refining and petrochemical facilities to be made outside the U.S. with the result that the world market share of foreign producers would increase while U.S. market share declines.

NPRA policy on import tariffs and fees does reflect a concern that was brought to the Subcommittee's attention in the testimony of the Independent Refiners Coalition, whose members are also members of this association. Although NPRA strongly opposes any increase in petroleum tariffs, our association policy clearly recognizes that an increase in the tariff on imported crude oil would necessitate a higher tariff on imported products to allow domestic refining and downstream industries to remain competitive. Our industries are already very concerned about the reduced international competitiveness of the U.S. refining and petrochemical industries as the result of the extremely high environment, health and safety expenditures that have to be made over the coming years. These expenditures for the refining sector are detailed in the just released August 1993 National Petroleum Council study entitled U.S. Petroleum Refining; Meeting Requirements for Cleaner Fuels and Refineries. While NPRA's policy does not specifically suggest the necessary level of the product differential, the NPC report includes some per gallon costs associated with gasoline manufacture under the Clean Air Act and other environmental strictures.

The tariffs on both crude oil and refined products proposed by Rep. Andrews would impose a new and more restrictive regime on imports, and would certainly be raise charges of violations of the GATT and would invite retaliation by other nations.

Sincerely,

Urvan R. Sternfels

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TESTIMONY OF THE EXPORT SOURCE COALITION

ON PROPOSAL TO LIMIT THE EXPORT SOURCE RULE AS PROPOSED IN 1992 BILL (H.R. 5270)

BEFORE THE WAYS & MEANS SELECT REVENUE MEASURES SUBCOMMITTEE

U.S. HOUSE OF REPRESENTATIVES

September 21, 1993

Thank you for the opportunity to submit this testimony for the record on behalf of the Export Source Coalition. The Export Source Coalition is made up of many of our nation's leading exporters. Attached is a list of the members of the group.

As a group formed specifically to promote tax policies favorable to U.S. exports, the group's testimony does not take a position on any of the other items being considered today by the Subcommittee, but rather limits its comments to the proposal to limit the export source rule benefits as proposed in section 203 of H.R. 5270 (1992).

Before getting into the specifics of the provision, we would like to take a step back and discuss the role of the export source rule in our economy today. The proposal to cut back on the benefits provided by the export source rule must be evaluated against the backdrop of recent U.S. export performance. After slumping in the early 1980s, the volume of merchandise exports has doubled between 1983 and 1991, with the overwhelming majority of that surge (over 80 percent) occurring after 1986. U.S. exports rose to a then record of $424 billion in 1991, notwithstanding the recession experienced in the domestic market,[1] and set a new record of $448.2 billion in 1992.[2]

While the export source rule cannot by itself be credited for all of this success, we must not ignore its beneficial effects. The export source rule became a powerful export incentive when Congress reduced the corporate income tax rate in the 1986 Tax Reform Act. In this context, the source rule serves to lower manufacturers' worldwide effective tax rate -- but not below the U.S. rate. As such, it gives U.S. manufacturers a competitive edge over many of our foreign counterparts who must pay the higher foreign tax rates on their operations.

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[1] Lester A. Davis, U.S. Department of Commerce, U.S. Jobs Supported by Merchandise Exports, p. 20 (April 1992) (hereinafter cited as "1992 Commerce Report").

[2] Fortune Magazine, p. 130 (June 14, 1993) (copy attached).

While the export source rule did not start out as an incentive provision, it has evolved into one of the few, GATT legal provisions that works as an export incentive remaining in our tax code. It works by implementing a simple, "rough justice" approach to separating foreign source sales income from U.S. source production income.

This incentive is not only good for American exporters, it is good for American jobs. A 1992 Commerce Department Report states that the increase in American exports after 1986 added 2.2 million jobs by 1990 to the already existing 5 million export related U.S. jobs. The total jobs supported by exports includes jobs directly required to produce the exported products as well as those jobs indirectly required upstream, to produce the intermediate inputs and capital goods used in producing exports, and downstream to provide the transportation and other services used in moving the goods to port. Stated another way, an average of 19,100 U.S. jobs were supported by each billion dollars of U.S. merchandise exports in 1990. In the manufacturing sector, merchandise exports contributed almost all of the job growth from 1986 to 1990.[3]

The large surge in U.S. exports was broadly based across most U.S. industrial sectors. Indeed, the Commerce Department Report referred to above states that among the ten industries with the largest number of jobs supported by exports, eight showed large increases in the number of those jobs, and four of those eight had job growth above 50 percent. Those industries with the largest job related growth include, motor vehicles and parts, electronic components and electronic computing equipment, aircraft and aircraft parts and industrial chemicals.[4]

The increase in merchandise exports also accounted for a steadily rising proportion of U.S. economic growth. Merchandise exports' contribution to total gross domestic product rose from 5.3 percent to 7.3 percent between 1986 and 1990. These exports also accounted for 41 percent of U.S. gross domestic product growth (in terms of 1982 dollars). This contribution to the U.S. gross domestic product growth has been rising steadily from 14 percent in 1986 to 88 percent in 1990.[5]

Finally, it should be noted that the source rule is not just a provision which helps the large U.S. companies that are our major exporters. Rather, to the extent small companies are exporting, their tax burden are also reduced. Indeed, the Fortune Magazine report on reports indicated that most of the exporting increase this year came from small and medium sized companies.[6] This finding corresponds well with a survey conducted by our coalition as far back as 1985, which found that small companies were exporting significant portions of their products. In fact, the smaller companies surveyed were exporting a larger proportion of their total sales than the larger companies surveyed during this same period. As a result, a change in the export source rule might have a more severe effect on some small companies than on the "typical" multinational large company because the small companies in our survey were more heavily oriented towards exports than the large companies.[7]

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[3] 1992 Commerce Report, p.iii.

[4] 1992 Commerce Report, pp.10-11.

[5] *Id*. at pp.4-5.

Given this success record and given the American economy's dependence on the future success of U.S. exports, we urge you not to adopt the cut back in the export source rule as proposed by H.R. 5270. With that general background, we turn now to the specifics of the proposal.

I. Background:

Under current law, goods that are manufactured in the United States and sold abroad generate a combination of manufacturing and sales income to the same taxpayer. In such cases, present law permits taxpayers to apply a mechanical apportionment formula, which in most cases treats approximately one-half of the U.S. combined manufacturing and foreign sales income as manufacturing income attributed to U.S. sources and the other one-half as selling income attributed to foreign sources.[8] The amount of foreign source income generated for export transactions is crucial because foreign source income is eligible for the foreign tax credit. Thus, companies paying some rates of foreign tax in excess of U.S. rates can utilize their excess credits to reduce or eliminate U.S. tax on other foreign income.

For taxpayers that export their products through Foreign Sales Corporations (FSCs), however, the maximum amount of foreign source income which can be earned is substantially reduced. Under the FSC rules, companies exporting through a FSC can only obtain foreign source income equal to a maximum 25 percent of their total combined taxable income. That is because a FSC provides an outright exemption of about 15 percent of combined income.

II. Proposal:

The proposal would impose a limit on the amount of the manufacturing and sales income of the U.S. exporter that can be attributable to manufacturing activities where the inventory goods are sold by the taxpayer to a related person. Under the proposal the amount attributable to manufacturing activities cannot be less than the portion of the combined income of the taxpayer and related person attributable to the inventory property that would have been apportioned to manufacturing activities under the current law rules had both parties been treated as one U.S. taxpayer.

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[6] Fortune Magazine, p. 130 (June 14, 1993).

[7] Gary C. Hufbauer and Arthur Hammond-Tooke, U.S. Export Competitiveness and Source-of-Income Rules (Jan. 1988).

[8] Where an independent factory price exists and the sale is made through a foreign branch, the taxpayer may determine the amount of U.S. and foreign source income based on that independent price.

Thus, if a U.S. manufacturer sells its electronics components to its foreign subsidiary at a price that yields it a $100 profit and the subsidiary resells these components within its jurisdiction at a price that yields it a $30 profit, the amount of the U.S. manufacturer's income that would be allocated to manufacturing activities under the current law rules ($50) cannot be less than 50% of the combined income of both entities or $130/2=$65. Thus, the amount of the U.S. manufacturer's income allocated to U.S. sources must be $65, with only $35 allocated to foreign source sales income.

III. Response:

- **This proposal undermines the primary tax incentive for U.S. exports.**

While the proposal is intended to simplify and rationalize the foreign income tax provisions, it not only fails to achieve these goals, but more importantly it undermines the most effective U.S. tax incentive for exports. The provision represents a substantial cutback on the current export source rule. As such, if enacted, it can only have an adverse effect on future growth of exports.

One of the goals of the new administration is to support the ever increasing level of U.S. exports. For example, while sales of the Fortune 500 companies dropped in 1991, exports of the list's 50 largest exporters increased 10 percent.[9] In 1992, total exports increased by 6.2%[10] 1991 and 1992 were not just isolated events. This pattern of increases in exports has been occurring since 1986, the year when the export source rule became a widely used incentive, has been dramatic. Since 1986, exports have risen more than 72 percent.[11] In contrast, exports only rose 1.7 percent between 1980 and 1986, with 1986 being the only year during the first six years of the decade with exports exceeding the level set in 1980.[12]

The dramatic increase in exports since 1986 has significantly decreased our trade deficit. In the first quarter of 1992 the trade deficit was just $17.5 billion, down from $18.5 billion in the last quarter of 1991. While the current trade deficit has increased somewhat since then, it still represents a significant decrease from the $152 billion annual deficit reached in 1986.[13]

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[9] Fortune Magazine, p.94 (June 29, 1992).

[10] Fortune Magazine, p. 130 (June 14, 1993).

[11] See, 1992 Commerce Report, p.20.

[12] Id.

Yet despite these advances, our balance of trade is still negative and our economy is not on a strong domestic growth pattern yet. In order to remedy this trade deficit and to insure future growth, we must consider major policy actions that expand exports, not provisions that are sure to reduce them.

This policy appears to have been embraced by the Clinton Administration, due largely to the effect of exports on unemployment. For example, a 1992 Commerce Department study found that every $52,230 in U.S. merchandise exports supports on average one job.[14] Any export cut back will reduce these jobs. As such, the Administration has chosen to (and Congress should also choose to) encourage multinationals to manufacture in the U.S., rather than cutting back the few export incentives that remain for U.S. manufacturers.

- **The proposal disproportionately affects similarly situated taxpayers.**

In essence, the provision would reduce the U.S. manufacturer's foreign source income by an amount equal to one-half of the foreign affiliate's income. Since foreign affiliates of different companies make profits based on varying levels of marketing, servicing and other activities, the provision will have a differential impact on every affected company. Those companies with greater foreign marketing efforts will be penalized more than those with less extensive foreign networks. Similarly, because the provision does not apply to companies who distribute their products through foreign branches or who sell directly to unrelated distributors, similarly situated taxpayers with different distribution networks will be differentially impacted.

- **The proposal introduces a considerable complicating feature into the export source rule.**

The proposal would require extensive regulations that would make the foreign area significantly more complex. For example, it does not state how a taxpayer would determine the portion of the foreign affiliate's income that is attributable to the exported product where the foreign affiliate incorporates the U.S. manufacturer's components into another product which is sold to third party customers. Similarly, many companies do not have data relating to resale profits of individual product sales of their foreign affiliates. And no information exists to distinguish between sales of products purchased from FSCs as opposed to other U.S. manufacturers. In addition, if a chain of sales, rather than a single sale, is used to dispose of the product, taxpayers would presumably be required to obtain sales information of each foreign affiliate along this chain. Other administrative difficulties are sure to arise where a U.S. manufacturer manufactures more than one product with overlapping costs, or where a sales affiliate sells more than one product with overlapping costs. At this time of increasing tax code complexity, let's not now add to this unfortunate trend.

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[13] The Economist, p.26 (July 4-10, 1992).

[14] 1992 Commerce Report, pp.1-2.

- **The proposal's potential application to sales sold through FSCs would have a disastrous effect on exports.**

While the proposal is somewhat ambiguous, it could be interpreted to apply to FSC sales as well as sales sold directly to foreign affiliates. By statute, companies that utilize FSCs are required to limit their foreign source income to 25 percent of the combined taxable income of the taxpayer and the FSC. Since the statute already limits the foreign source income generated by a FSC (and this limiting feature has already reduced taxpayer usages of FSCs) applying this provision to FSC sales would thus further discourage the use of FSCs.

A simple example should illustrate this concern quite clearly. Assume that a U.S. corporate manufacturer exports to its foreign affiliate through a wholly owned commission FSC and uses the combined taxable income method to determine the income of the FSC. Assume the combined taxable income from the exports of the U.S. corporate manufacturer and the FSC is $100 and the net income earned by the foreign affiliate with respect to its subsequent disposition of the product is $30.

Under current law, $15 of the combined taxable income is exempt from U.S. tax, and an additional $8 is taxable to the FSC with no foreign tax credit. The remaining $77 is taxed to the U.S. corporation. Of this amount, $25 may be sourced foreign and $52 would be domestic source because of the rule that requires that the 50-50 divided source rule be applied to the income of the manufacturer had the sale been made to or by a DISC. Thus, up to 40 percent of the income from the export may be exempted from U.S. tax through a combination of the FSC exemption and the foreign tax credit benefit ($15 exemption plus $25 foreign source income). Had the same sale been made by the U.S. manufacturer directly to its foreign affiliate (with title passing outside the U.S.), up to 50 percent of the income from the export could be exempted through the application of the export source rule. Thus, the FSC rules already have a limited export incentive benefit.

Under the proposal, these benefits would be curtailed dramatically. Rather than giving rise to $25 of foreign source income, the foreign source income of the U.S. manufacturer would be limited to only $10.[15]

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[15] This limited benefit is arrived at as follows: The portion of the $100 combined taxable income that can be foreign is limited to that amount which would be foreign under the DISC rules. Under the DISC rules, the U.S. manufacturer's income (which is $50 or 100/2) would have to be added to the foreign affiliate's income ($30). The portion of the U.S. manufacturer's income that can be allocated to U.S. production sources cannot be less than 50% of this

(continued...)

We believe that the application of this provision to any FSC sale is completely inappropriate. Since the FSC regime has not been challenged under the rigorous GATT legal constraints, it should not be further reduced as a way to raise revenue for other foreign tax provisions which do not benefit U.S. exports.

* * *

In sum, the export source rule change is a bad policy decision that will reduce exports, jobs and future economic growth. It also will increase the already large administrative burden of the U.S. international tax regime. For these reasons, we strongly urge that this provision not be pursued. We would be happy to supply any additional information you may need.

Paul W. Oosterhuis

Roseann M. Cutrone

Skadden, Arps, Slate, Meagher & Flom

on behalf of the

Export Source Rule Coalition

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[15] (...continued)
$80 combined income or $40. Since the U.S. manufacturer only has $50 of income to be allocated under the DISC rules, only $10 remains as an amount which can be allocated to foreign source income. Thus, in this case the benefit of the FSC sale is reduced from 40 percent to only 25 percent of the combined income of the manufacturer and the FSC.

U.S. EXPORTERS KEEP ON ROLLING

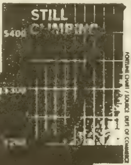
For the second straight year America led the world in merchandise exports, just ahead of Germany. Japan, despite its big surpluses, was a distant third.

■ *by Therese Eiben*

YOU HEAR A LOT about the U.S. trade deficit but not much about the brighter side of the picture—exports. In 1992 the U.S. had a record $448.2 billion in merchandise exports. Though the rate of growth slowed to 6.2% from 7.1% in 1991, America ranked No. 1 in the world for the second straight year, beating Germany by $18 billion and Japan by more than $100 billion. Says J. David Richardson, an economist at the Institute for International Economics in Washington, D.C.: "Virtually all the flattening of export growth was due to recession abroad and not to declining competitiveness of American companies."

Chrysler exports these right-hand-drive Cherokees to a hot market—Japan.

Most of the increase came from small and medium-size companies, a sharp change from the past. Exports of the top 50 grew only 1.0%. "If this continues, it would be a sea change," says Richardson. Historically, exporting has been a big-company enterprise.



FORTUNE CHART / SOURCE: DEPT. OF COMMERCE

Boeing remains the largest U.S. exporter, a rank it has held for the past four years. General Motors, which last was No. 1 in 1988, came in second, but there is a significant difference between the two in the role exports play in their businesses. Boeing has no manufacturing operations abroad, and exports accounted for 57.5% of its total sales, vs. 10.6% of GM's. Most of the automaker's exports were "intracompany transfers" of components and materials from U.S. operations to foreign affiliates. Such sales make up fully a quarter of all U.S. exports. Another fifth of exports are generated by U.S. affiliates of foreign companies.

Among the Big Three U.S. automakers, only Chrysler had significant export growth—14.3%. In addition to increased intracompany transfers to its Bramalea, Ontario, plant—where the Dodge Intrepid, Chrysler Concorde, and Eagle Vision are put together—Chrysler reported a 15% rise in other exports.

Of the eight computer companies on FORTUNE's list, six had double-digit export growth. Intel led with a 21.3% increase. Apple was up 20.8%. Compaq, with a 16.2% increase, celebrated its tenth anniversary in business by dominating the European notebook market. According to Lee Mercer, a former Commerce Department official and now corporate export manager of Digital Equipment, further growth may depend on how quickly the Clinton Administration moves to relax restrictions on technological exports. Mercer says DEC reduced the power of one of its computers to comply with current export controls. Says he: "This is a classic example of retarding technology to meet an unrealistic definition."

Will the U.S. stay on top for another year? New export orders declined in March for the first time since the National Association of Purchasing Management began tracking them in 1988, but went back up in April. NAPM Chairman Robert J. Bretz thinks the dip will not be repeated. Says he: "The businesses that export in a major way are absolutely convinced that they can compete in quality and price in a global market." With smaller companies catching on to the game, watch for U.S. exporters to keep racking up points. F

MAJOR FOREIGN EXPORTERS

Foreign-owned plants built to serve the American market have begun exporting in a big way

	Exports from the U.S. (1992, in millions)	**U.S. employees**
Toyota	**$2,000.0**	**16,000**
Matsushita	**$1,537.0**	**10,000**
Honda	**$1,482.5**	**14,800**
Siemens	**$780.0**	**34,500**

U.S. [illegible]PORTERS

			MAJOR EXPORTS	U.S. EXPORTS 1992 $ millions	% change from 1991	As % of total sales %	RANK	TOTAL SALES 1992 $ millions	FORTUNE 500 SALES RANK
1	1	**BOEING** Seattle	Commercial aircraft	17,486.0	(2.1)	57.5	1	30,414.0	12
2	2	**GENERAL MOTORS** Detroit	Motor vehicles and parts	14,045.1[1]	(6.8)	10.6	35	132,774.0	1
3	3	**GENERAL ELECTRIC** Fairfield, Conn.	Jet engines, turbines, plastics, medical systems	8,200.0	(4.8)	13.2	27	62,202.0	5
4	4	**INTL. BUSINESS MACHINES** Armonk, N.Y	Computers and related equipment	7,524.0	(1.9)	11.6	31	65,096.0	4
5	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
6	6	**CHRYSLER** Highland Park, Mich.	Motor vehicles and parts	7,051.8	14.3	19.1	14	36,897.0	11
7	7	**MCDONNELL DOUGLAS** St. Louis	Aerospace products, missiles, electronic systems	4,983.0	(19.1)	28.5	6	17,513.0	23
8	12	**PHILIP MORRIS** New York	Tobacco, beverages, food products	3,797.0	24.0	7.6	42	50,157.0	7
9	11	**HEWLETT-PACKARD** Palo Alto, Calif.	Measurement and computation products, systems	3,720.0	15.4	22.6	10	16,427.0	24
10	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
11	14	**MOTOROLA** Schaumburg, Ill	Communications equipment, semiconductors	3,460.0	18.2	25.9	8	13,341.0	32
12	10	**UNITED TECHNOLOGIES** Hartford	Jet engines, helicopters, cooling equipment	3,451.0	(3.8)	15.7	17	22,032.0	16
13	9	**CATERPILLAR** Peoria, Ill.	Heavy machinery, engines, turbines	3,341.0	(9.9)	32.8	4	10,194.0	44
14	13	**EASTMAN KODAK** Rochester, N.Y	Imaging, chemicals, health products	3,220.0	6.6	15.6	18	20,577.0	19
15	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
16	17	**INTEL** Santa Clara, Calif	Microcomputer components, modules, and systems	2,339.0	21.3	39.1	3	5,986.4	91
17	16	**DIGITAL EQUIPMENT** Maynard, Mass.	Computers and related equipment	1,900.0	(13.6)	13.5	24	14,027.1	27
18	18	**ALLIED-SIGNAL** Morristown, N.J	Aircraft and automotive parts, chemicals	1,810.0	4.7	15.0	21	12,089.0	36
19	20	**UNISYS** Blue Bell, Pa	Computers and related equipment	1,795.8	12.4	21.3	11	8,421.9	62
20	[illegible]	**SUN** [illegible]	[illegible]	[illegible]	[illegible]	40.2	2	[illegible]	[illegible]
21	21	**RAYTHEON** Lexington, Mass.	Electron. systems, engineering and constr. projects	1,760.0	13.1	19.3	[illegible]	9,118.8	54
22	22	**WEYERHAEUSER** Tacoma	Pulp, newsprint, paperboard, logs, lumber	1,500.0	(3.2)	16.2	16	9,259.9	51
23	25	**MERCK** Rahway, N.J	Health care products, specialty chemicals	1,489.8	11.0	15.2	20	9,800.8	47
24	26	**MINNESOTA MINING & MFG.** St. Paul	Industrial, electronic, and health care products	1,433.0	12.4	10.3	36	13,883.0	28
25	31	**WESTINGHOUSE ELECTRIC** Pittsburgh	Electrical products [illegible]	[illegible]	[illegible]	11.2	32	[illegible]	[illegible]
26	●	**IBP** Dakota City, Neb.	Fresh/frozen beef, pork, and related by-products	1,300.0	30.3	11.7	30	11,129.7	42
27	33	**XEROX** Stamford, Conn	Copiers, printers, doc. processing svcs., supplies	1,292.0	24.2	7.1	46	18,089.0	21
28	23	**DOW CHEMICAL** Midland, Mich	Chemicals, plastics, consumer specialties	1,247.0	(9.4)	6.5	[illegible]	19,080.0	20
29	29	**TEXTRON** Providence	Aerospace and commercial products	1,244.0	6.2	14.9	22	8,347.5	63
30	27	**INTERNATIONAL PAPER** Purchase, N.Y.	Pulp, paperboard, wood products	1,200.0	—	8.8	40	[illegible]	32
31	●	**RJR NABISCO HOLDINGS** New York	Food and tobacco	1,171.0	16.9	7.4	43	15,734.0	26
32	28	**UNION CARBIDE** Danbury, Conn	Chemicals, plastics	1,125.0	(6.3)	18.2	[illegible]	6,167.0	88
33	37	**COMPAQ COMPUTER** Houston	Computers and related equipment	1,104.0[2]	16.2	26.7	[illegible]	4,132.2	119
34	30	**HOECHST CELANESE** Bridgewater, N.J	Chemicals, plastics, fibers	1,072.0	(7.4)	15.2	[illegible]	7,044.0	[illegible]
35	38	**FMC** Chicago	Arma[illegible] chemicals	997.7	9.3	28.0	[illegible]	[illegible]	[illegible]
36	35	**ABBOTT LABORATORIES** Abbott Park, Ill	Drugs, diagnostic equipment	996.7	4.1	12.6	[illegible]	7,894.2	66
37	39	**MILES** Pittsburgh	Chemicals, health care and imaging products	956.0[4]	9.0	14.7	[illegible]	6,499.0	92
38	●	**APPLE COMPUTER** Cupertino, Calif	Computers, related equipment	934.7	20.8	13.2	[illegible]	7,086.5	76
39	32	**MONSANTO** St. Louis	Food ingred., herbicides, chemicals, drugs	927.0	(17.8)	10.9	[illegible]	8,485.0	[illegible]
40	43	**BRISTOL-MYERS SQUIBB** New York	Drugs, medical devices, consumer products	915.0[3]	13.4	7.8	41	[illegible]	40
41	45	**EXXON** Irving, Texas	Petroleum, chemicals	906.0	21.8	0.9		103,547.0	
42	34	**ALUMINUM CO. OF AMERICA** Pittsburgh	Aluminum products	886.0	(8.4)	9.2		9,588.4	[illegible]
43	●	**GEORGIA PACIFIC** Atlanta	Pulp, building products, containerboard, paper	859.0	30.0	7.3	[illegible]	11,847.0	[illegible]
44	44	**LOCKHEED** Calabasas, Calif	Aerospace products, electronics, missile systems	831.0	24.8	10.0	[illegible]	10,138.0	45
45	42	**HONEYWELL** Minneapolis	Building, industrial, and aviation control systems	830.0	2.7	13.3	25	[illegible]	[illegible]
46	40	**COOPER INDUSTRIES** Houston	Petroleum and industrial equipment	805.0	(3.6)	13.1	[illegible]	6,158.5	89
47	●	**CUMMINS ENGINE** Columbus, Ohio	Diesel engines, diesel engine parts	781.0	48.5	20.8	[illegible]	3,749.2	132
48	46	**DEERE** Moline, Ill	Farm and industrial equipment	778.0	9.1	11.2	33	6,960.7	79
49	48	**TENNECO** Houston	Farm, construction, and auto equipment	702.0	1.4	5.2	49	13,606.0	[illegible]
50	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
TOTALS				135,440.2				1,055,383.8	

● Not on last year's list [1] FORTUNE estimate [2] Excludes some U.S. exports [3] Exports from U.S. and Canada. [4] Owned by Bayer AG, Germany

EXPORT SOURCE COALITION

Abbott Laboratories
Allied-Signal, Inc.
Aluminum Company of America
American Electronics Association
Analog Devices, Inc.
Apple Computer, Inc.
Arthur Anderson & Company
Burridge Associates
Can Manufacturers Association
Caterpillar Inc.
Champion International Corporation
Chrysler Corporation
Combustion Engineering
Computer and Business Equipment Manufacturers Association
Control Data Corporation
Cray Research, Inc.
Data General Corporation
Deloitte & Touche
Digital Equipment Corporation
Dow Chemical
Dow-Corning Corporation
Dresser Industries
Eastman-Kodak Company
Electronics Industry Association
Emergency Committee for American Trade
FMC Corporation
Ford Motor Company
General Motors Company
Graco, Inc.
Hewlett Packard Company
Intel Corporation
International Paper Company
Johnson & Johnson
Kimberly-Clark Corporation
Medtronic, Inc.
Merck & Company
Minnesota Mining and Manufacturing Co.
Monsanto Company
National Association of Manufacturers
NCR Corporation
Olin Corporation
Perkin Elmer Corporation
Pharmaceutical Manufacturers Association
Premark International
Raytheon Compnay
RJR Nabisco
Rockwell International
Schering-Plough Corporation
Scientific-Atlanta, Inc.
Tandem Computers, Inc.
Tektronix, Inc.
Textron, Inc.
Union Carbide Association
Unisys Corporation
Upjohn Company
U.S. Chamber of Commerce
Warnaco, Inc.
Weyhaeuser Company
W.R. Grace and Company
Xerox Corporation

Testimony before the Committee on
Ways and Means of the House
of Representatives
Subcommittee on Select Revenue
Measures
Washington, D.C., September 22, 1993

Statement of Joel B. Slemrod

Professor of Economics, Business Economics and Public Policy and Director, Office of Tax Policy Research, The University of Michigan, and Research Associate, National Bureau of Economic Research

My name is Joel Slemrod. I am Professor of Economics, Business Economics and Public Policy and also Director of the Office of Tax Policy Research at the University of Michigan, and Research Associate of the National Bureau of Economic Research. I am submitting this testimony in my capacity as Research Director of the International Tax Policy Forum. Founded in 1992, the International Tax Policy Forum is an independent group of major U.S. multinationals with a diverse geographic and industry representation. The primary purpose of the Forum is promoting research and education on U.S. taxation of foreign-source income (a list of members is attached). The Forum currently is sponsoring seven academic research projects which address the theory and effects of U.S. rules for taxing foreign-source income.

1. Avoiding Piecemeal Tax Policy

Because foreign direct investment is critical to the success of multinational enterprise, which comprises an essential and growing part of any modern economy, the taxation of foreign-source income must be carefully crafted to balance the goals of supporting prosperity, equitable sharing of the tax burden, and simplicity. For this reason it is important that our international tax policy not be made piecemeal, but be made recognizing the linkages to our overall tax policy and the tax policies of other countries.

Provisions that on the surface may appear to affect only particular foreign activities can have an important effect on the domestic as well as the foreign operations of a U.S. multinational firm. For example, the rules governing the allocation of interest expense between foreign and domestic-source income can affect the cost of raising capital for U.S.-located investment, making it in some situations higher than that of purely domestic companies or foreign-based multinationals; the rules governing the allocation of R&D expenditure can affect the viability of domestically-located, as well as foreign-located, R&D. This implies that in order to assess the net effect of the tax system on R&D, one must take into account not only the "domestic" provisions that come immediately to mind -- expensing and the R&D credit -- but also the source allocation rules. This example highlights that it makes no sense to have two aspects of the tax code working at cross purposes.

It is also important to consider the interaction between U.S. tax policy and the policies of other countries. Because of the pervasive problem of overlapping tax jurisdictions, U.S. tax policy ought not to be devised in isolation from other countries' policies. The United States ought to continue its efforts to cooperate with other countries to avoid double taxation and ensure single taxation, and to lead by example toward establishing a worldwide tax system in which no investment is unduly penalized, or favored, because capital crosses borders, or because of the nationality of the company doing the investing. In this way tax policy is consistent with the free trade of capital and ideas so as to make best use of our resources.

2. The Foreign Tax Credit

Tax policy is supportive of economic prosperity when it does not unduly penalize any one kind on investment; in particular there is no justification, from a global perspective, for taxing foreign direct investment at a higher rate than domestic investment. As long as all countries continue to levy tax on income earned within their borders, avoiding an undue double tax penalty on foreign direct investment requires the home country to abstain from fully taxing foreign-source income.

All of our major trading partners have one of two systems for avoiding double taxation of the income from foreign direct investment. Countries such as France and the Netherlands simply exempt from taxation their resident multinationals' foreign-source income. Other countries such as Japan and the United Kingdom tax foreign-source income, but allow a limited credit for income taxes paid to foreign governments; this is the system in use in the United States.

Because world prosperity is furthered by these conventions, it is therefore important that the United States uphold this principle. Abandoning this principle, for example by allowing a deduction rather than a credit for foreign taxes, would single out one category of investment -- equity-financed foreign investment by U.S.-resident companies -- for higher tax than virtually any other category of investment.

3. The Compliance Cost of Taxing Foreign-Source Income

All participants and observers of the U.S. system of taxing multinationals agree on one thing -- that it is extraordinarily complex, and this complexity is increasing. Just how complex is suggested by a recent comprehensive study of corporate compliance costs which estimated that, for 1300 of the largest U.S. corporations, 40% of the total cost of complying with the federal corporate income tax law was related to foreign-source income, a fraction which is far larger than the fraction of total tax paid to the U.S. government on foreign-source income. These companies ranked only two tax provisions -- depreciation and the alternative minimum tax -- ahead of the foreign-source income provisions as a source of complexity.

Not all the costs of complexity can be measured in dollars. One of the casualties of increasing complexity, combined with limited corporate tax department budgets has been a deterioration in the quality of the information conveyed to the IRS; this increases the capriciousness of the tax system, and jeopardizes its fairness.

Some tax system complexity is inevitable to protect the revenue base and ensure fairness, in the face of highly complex real and financial activities of multinational corporations. But in many cases the costs of complexity outweigh the policy advantages. For this reason we encourage Congress to continue to seek changes that simplify the international tax system while not compromising the tax system's other goals. We believe that such changes exist.

MEMBERSHIP OF INTERNATIONAL TAX POLICY FORUM

September 1993

- American Express Company
- Caterpillar, Inc.
- CIGNA Corporation
- Citicorp
- Dow Chemical Company
- Eastman Kodak Company
- Emerson Electric Company
- Exxon Corporation
- General Electric Co.
- General Motors Corporation
- Goodyear Tire & Rubber Company
- Hewlett-Packard Company
- Honeywell, Inc.
- IBM Corporation
- Johnson & Johnson
- Levi Strauss & Co.
- Merck & Co., Inc..
- Merrill Lynch and Co., Inc.
- Mobil Corporation
- Philip Morris Companies, Inc.
- Premark
- Procter & Gamble Company
- Tenneco, Inc.
- United Technologies Corporation
- Xerox Corporation

TESTIMONY OF UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

HOUSE WAYS AND MEANS
SELECT REVENUE MEASURES SUBCOMMITTEE

REGARDING

CERTAIN PROPOSALS INCLUDED ON THE
SEPTEMBER 21, 1993 HEARING AGENDA

I. INTRODUCTION

Among the Miscellaneous revenue measures to be considered by the Subcommittee at its September 21, 1993 hearing are two tax proposals which will adversely impact the international operations of U.S. multinational corporations.

These two provisions are the following:

- A proposal based upon a provision in HR5270, as introduced in the 102nd Congress, to modify the method by which income from the sale of inventory property is sourced; and
- A proposal to change the foreign tax credit to a deduction.

Each of these provisions will be individually discussed in this statement.

The United States Council advances the global interests of American business both at home and abroad. It is the American affiliate of the International Chamber of Commerce (ICC), the Business and Industry Advisory Committee (BIAC) to the OECD, and the International Organisation of Employers (IOE). As such, it officially represents U.S. business positions in the main intergovernmental bodies, and vis-a-vis foreign business and their governments. Its objective is to promote an open system of world trade, finance, and investment.

II. PROPOSAL TO ALTER RULES ON SOURCE OF INCOME FROM EXPORTS

Section 203, Source of Income from Certain Sales of Inventory Property.

Under current law, taxpayers that manufacture goods in the U.S. and export them abroad are allowed to apply an apportionment formula, which generally treats one half of the combined income as production income attributable to U.S. sources, and the other one half as selling income attributable to foreign sources. If an independent factory price exists, the taxpayer determines the amount of U.S. and foreign source income based on that independent factory price.

Last year HR 5270 proposed to change the amount of income a U.S. corporation could treat as attributable to foreign sources when the export property is sold abroad through a related party. This was accomplished by requiring that the amount of income attributable to U.S. production activities could not be less than the portion of the combined income of the exporter and the related person attributable to the export property that would have resulted had both parties been treated as one U.S. taxpayer selling to the ultimate customer.

The U.S. Council expressed its opposition to this provision in a statement submitted to the House Ways and Means Committee on July 22, 1992. We continue to oppose it primarily because it is based upon a flawed assumption that the related foreign party generally performs no more functions that the U.S. exporter would have had it sold the export property directly. Foreign distributors almost always perform functions and incur risks different than those that a direct U.S. exporter incurs. This is especially true where the foreign related party further processes the product or incorporates it into a finished product.

Furthermore, even in situations where the distribution function performed is the same, determining the profit from the distribution would be extremely complex. It is not uncommon for large U.S. corporations (e.g. in the chemical industry) to be selling literally thousands of products in export. The burden in this case would be tremendous. For example, consider the following four cases:

- A U.S. exporter sells Product A to a related party who, in turn, sells it to a third party. The related party, however, sells many different products, not just Product A exported from the U.S. Under the proposed rule, taxpayers would be required to allocate costs among products to determine the profit attributable to U.S. export sales. This would be very difficult, and would be even more complicated if the related party sold Product A to a second related party, who in turn sold it to an unrelated party.

- A U.S. exporter sells Product A to a related party, who purchases the same product from other related and unrelated non-U.S. suppliers and sells to many customers at different prices. It would be very difficult to determine which customer purchased the U.S. supplied Product A, and at what price.

- A. U.S. exporter sells Product A to a related party, who also manufactures the same product. Product A is sold to many third parties at different prices. It would be very difficult to determine which customers purchased the U.S.-supplied product, and at what price.

- A U.S. exporter sells Product A to a related party, who further processes the material or incorporates it into a finished product, Product B. Product B is then sold to the final customer. Taxpayers then would be required to allocate the profit earned by the related party between Product A and the processes performed by the related party. It would be difficult to determine the value of the processes, depending on the type of technology involved and the extent of the work performed.

Each of these four examples are typical and could occur individually or in combination with any or all of the others.

We are also concerned that the economic effect of the provision, by reducing the amount of foreign source income that could be earned on exports, would be to reduce the incentive for U.S. taxpayers to produce products in the U.S. for export. The likely result could be fewer jobs, and less economic growth, in the U.S.

Finally, we are troubled by the one-way nature of the rule. It works only to increase - not decrease - income attributable to U.S. production. For example, if a U.S. exporter sells Product A to a related party who, in turn, resells the product for less than the price paid to the U.S. exporter, the amount of income attributable to U.S. production is not decreased by a portion of the resulting loss.

III. PROPOSAL TO ELIMINATE THE FOREIGN TAX CREDIT IN FAVOR OF A REDUCTION

We have not seen the legislative language incorporated in this proposal, but it would be reasonable to assume that the proposal would repeal Sections 901-908, Subpart A, Part III of the Internal Revenue Code. Since Section 164 of the Code already permits deduction of foreign income taxes, as an infrequently used alterative to the credit, such repeal would have the effect of drastically reducing the U.S. double taxation relief for foreign income taxes. While limiting foreign taxes to deductions would certainly be simpler, it is difficult for us to accept this as a serious proposal given its severe double tax consequences. In the 1970s, legislation sponsored by Senator Hartke and Representative Burke attempted to amend the Code to repeal the foreign tax credit, but the folly of such a provision, among other ill considered tax measures affecting U.S. multinationals in this bill, was clearly pointed out by more responsible legislators as well as by the business community, with the result that the Burke-Hartke proposals were soundly defeated. Despite this history, this ill-advised suggestion seems to be resurfacing.

A very simple illustration is sufficient to set this proposal in its proper perspective. Assume a U.S. multinational operates a branch in a European country where the corporate tax rate is 40 percent. The overall tax burden of this company with respect to the income of its European branch can be calculated as follows:

Income of Foreign Branch	$100.00
Foreign tax (@ 40%)	40.00
Balance after foreign tax	60.00
U.S. tax (@ 35%)	21.00
Net after tax profit	$ 39.00
Overall tax burden	$ 61.00
Effective overall tax rate	61%
Effective tax rate with existing credit	40%

(The above ignores the allocation and apportionment of expense which would act to increase the effective somewhat.)

The purpose of the foreign tax credit is to eliminate the burden of international double taxation, not to grant U.S. multinationals a tax preference with respect to foreign income. It seems that legislators often misunderstand the rationale behind the foreign tax credit mechanism which is designed to neutralize the added burden imposed upon taxpayers operating in two (or more) taxing jurisdictions. All of our trading partners have provisions in their laws to eliminate international double taxation, some by way of foreign tax credit approach (like the U.S.) and others by way of an exemption (territorial) approach. U.S. companies are already facing a competitive disadvantage in terms of higher tax burdens, as concluded by a study entitled U.S. International Tax Policy for a Global Economy, prepared for the U.S. Chamber Foundation by Price Waterhouse.

To unilaterally eliminate the foreign tax credit provisions from the U.S. Code, in favor of a deduction, would be insanity. It would play right into the hands of the foreign competitors of U.S. business. Corporate tax rates around the world now range from 33 percent to 50 percent, with most of such rates falling below 45 percent. How can U.S. multinationals be expected to compete in the foreign arena when the tax burdens they would suffer on foreign income, should the ill considered proposal become law, would range from 57 percent to 67 percent, compared to much lower burdens enjoyed by foreign multinationals?

The U.S. Council strongly urges that this provision be summarily dropped, particularly as it is totally inconsistent with Congress' current desire to improve the competitiveness of U.S. business vis-a-vis its foreign competitors.

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William F Paul
Senior Vice President

September 8, 1993

Honorable Charles B. Rangel
Chairman, Subcommittee on
Select Revenue Measures
Committee on Ways and Means
1105 Longworth Building
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

The Subcommittee on Select Revenue Measures will hold hearings this month on miscellaneous revenue measures. Some of them would affect United Technologies Corporation, and I wanted to provide you with our comments on the proposals of concern to UTC.

Among the international tax provisions, we would oppose the modification of the method by which income from the sale of inventory property is sourced. The so-called "sourcing rule" for export sales (also known as 863(b)) is a very established rule of international business, which treats inventory property produced within the U.S. and sold outside of the U.S. as 50 percent domestic-source (the deemed "production" portion of the income) and 50 percent foreign-source (the deemed "marketing" portion) for tax purposes. An example of inventory property is Pratt & Whitney spare parts sales.

The new proposal addresses a perceived abuse that could occur if the U.S. producer sold its products to a controlled foreign subsidiary (a "CFC") for distribution, at a price substantially lower than the price to the eventual foreign buyer. The new proposal would require a calculation of the 50% profit on the basis of total sales by the U.S. producer and CFC distributors. The total amount of profit allocable to U.S. sources could be no less than 50% of the combined income.

This rule would impose some additional administrative and compliance burdens on taxpayers like UTC. It may be difficult to determine what portion of a CFC's sales must be included in making the calculation. It would not otherwise have a substantial impact on UTC, because most of UTC's foreign sales are made directly to unrelated foreign buyers. In addition, because the transfer pricing rules of the Tax Code already address the perceived abuse at issue here, with very heavy penalties for noncompliance, the issue should not arise even when a CFC is used as a distributor.

UTC also opposes changing the foreign tax credit to a deduction. Since 1918, the income tax law has contained a provision for crediting foreign taxes against United States tax. The purpose of the credit is to prevent double taxation on the same item of income. The United States system of taxing income from both U.S. and foreign sources differs from the tax systems of most other industrialized countries where UTC's competitors are based. Changing the foreign tax credit to a deduction would thus put UTC at a competitive disadvantage relative to such foreign-based entities.

Other proposals would increase the administrative burden on U.S. companies, including a written substantiation of any meal or entertainment expense claimed as a business deduction.

Proposals which would deny deductions for interest paid to the IRS on underpayments, and increase the rate of interest on delinquencies could penalize corporations for legitimate differences of opinion with the IRS on tax liability. The proposal to increase the rate of withholding on bonuses from 28 percent to 36 percent is unfair if the employee is not in the top tax bracket.

UTC is also concerned with changes in the tax law that would disallow deductions for compliance with certain environmental laws.

Carrier Corporation would be adversely affected by proposals to add to the list of taxable ozone-depleting chemicals hydrochlorofluorocarbons (HCFCs). From a public policy standpoint, Carrier would view such a change as counterproductive since HCFCs are the interim step to developing alternatives to ozone-depleting CFCs. Any taxes now on HCFCs would be detrimental because a new HCFC tax could divert resources from developing refrigeration alternatives that do not damage the ozone layer. As a matter of corporate policy, Carrier has chosen hydroflurocarbons (HFCs), the primary alternative known today, as its refrigerant of choice as it does not deplete the ozone layer. While incorporating HFCs wherever and whenever we can, HCFCs are still needed in transition so the industry can adapt all products to new chemical technologies.

We would be happy to discuss these issues further with you or your staff.

Sincerely,

William F. Paul

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PSA

Statement of the Public Securities Association before the House Committee on Ways and Means Select Revenue Measures Subcommittee

Submitted for the Record
September 23, 1993

The Public Securities Association (PSA) is pleased to submit this statement on one of the miscellaneous tax proposals pending before the Subcommittee. PSA is the international trade organization of banks and securities firms that underwrite and trade U.S. Government and agency securities, mortgage-backed securities, municipal securities and money-market instruments.

On July 13, 1993 PSA provided written and oral testimony on a number of tax-exempt bond-related proposals before the Subcommittee. Since that time, an additional proposal of interest to PSA has been added to the Subcommittee's agenda. This statement expresses our view on the issue of withholding of U.S. source interest income earned by foreigners

Under current law, U.S. source income earned by foreigners is generally subject to a 30-percent withholding tax. Among the exceptions to the tax, however, is "portfolio" interest earned on U.S. debt instruments. A bill introduced earlier this year by Congressman Andrew Jacobs, H.R. 220, would reinstate the withholding tax on portfolio interest, which was repealed in 1984.

H.R. 220 would directly result in an increase in interest rates paid by the federal government on its borrowing. It would also increase borrowing costs for all other entities who sell debt instruments into the international market, including corporations and homebuyers, whose mortgages are financed through the mortgage-backed securities market. Because of its effect on interest rates and because of the deleterious effect that higher rates could have on the U.S. economy in general, PSA opposes H.R. 220.

H.R. 220 would have a particularly adverse effect on the market for U.S. Treasury securities. Of the $2.8 trillion in marketable U.S. Treasury securities outstanding as of March 31, 1993, $528 billion, or approximately 19 percent, were held by foreign investors. At certain auctions of government securities, foreigners buy 40 percent or more of new issues offered by the Treasury. The enormous flow of foreign capital into Treasury securities helps to make the U.S. government securities market the most liquid securities market in the world and reduces interest rates paid by the federal government and American taxpayers.

Instituting a withholding tax would make Treasury securities less attractive to foreign investors, who would demand a higher return as compensation. A higher return for foreign investors translates into higher interest costs for the U.S. government, which will only serve to increase the budget deficit. Moreover, if H.R. 220 were enacted, the effect on interest rates would not be limited to U.S. Treasury securities. First, the proposed tax would apply to other debt securities, such as mortgage-backed securities and corporate bonds. In addition, an increase in interest rates in one market would spread to other markets as the economy adjusted to the new tax. Moreover, outstanding issues held by foreigners would be disadvantaged because many have "gross-up" provisions requiring issuers to redeem outstanding issues upon reinstatement of the tax. Issuers who were unable to gross up would essentially be prohibited from further access to the international markets.

Evidence that a foreign withholding tax would increase interest rates has already been provided by the financial markets. When the markets first learned that Congress was considering this tax option on Thursday, August 9, yields on Treasury securities and other U.S. debt instruments rose significantly, largely because of concerns over the proposal. Although the upward pressure on yields subsided when market participants understood that passage of the foreign withholding tax was not imminent, the markets are still wary.

In his testimony before this Subcommittee on September 21, 1993, Assistant Treasury Secretary Leslie Samuels stated the Clinton Administration's opposition to H.R. 220 for many of the reasons outlined here.

In sum, a withholding tax on U.S. source interest income earned by foreigners would raise interest rates for the U.S. Treasury, corporations, homebuyers and ultimately all entities who depend on the capital markets as a source of borrowing. By increasing the cost of borrowing for the Treasury, the tax would tend to increase the federal budget deficit. For these reasons, PSA opposes H.R. 220.

STATEMENT OF MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION
TO THE HOUSE COMMITTEE ON WAYS & MEANS
SUBCOMMITTEE ON SELECT REVENUE MEASURES
U.S. HOUSE OF REPRESENTATIVES
SEPTEMBER 21, 1993

The Securities Industry Association appreciates the opportunity to comment on HR 220, a bill to reinstate the tax on interest received by foreigners on certain portfolio investments.

The Securities Industry Association is the trade association representing almost 700 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types — investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over the counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

SIA strongly opposes the reinstatement of a 30% U.S. withholding tax on payments of interest income to foreign persons. The re-imposition of such a tax, repealed by Congress almost 10 years ago, would increase the costs of borrowing for all U.S. corporations and the U.S. Treasury, generate little incremental tax revenues, and cause a disruption of international capital flows. The resulting upturn in interest rates could sharply limit or hinder the deficit reduction contained in the recently enacted Omnibus Budget Reconciliation Act of 1993. Given the global competition for capital and the size of our federal debt, the U.S. can ill afford a tax that would drive foreign capital to other shores.

Past Experience & Current Markets

Until mid-1984, the U.S. imposed a 30% withholding tax on interest payments by U.S. issuers to foreign investors, subject to any reduction in rate or exemption by U.S. tax treaties. As a result, except for those U.S. corporations that were able to access the Euromarket through Netherlands Antilles finance subsidiaries, U.S. issuers, including the U.S. Treasury and major quasi-governmental agencies, were unable to tap directly large portions of the foreign capital markets, especially foreign private institutions and individuals.

At the time of the repeal of the withholding tax, Congress recognized the need for U.S. businesses to have access to the Eurobond market as a source of capital. The legislative history notes that, "the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market. . . . If tax-free access to the Eurobond market is important, such access should be direct."[1] The Eurobond market, where U.S. issuers borrowing through Netherlands Antilles finance subsidiaries could raise capital free from the 30% tax, was enjoying significant growth. In 1982, the peak year of Eurobond issuance by U.S. corporations, Eurobonds represented about 33% of the amount of domestic bond offerings.

Congress also determined that the withholding tax raised costs to U.S. issuers, while causing an under-utilization of U.S. resources and personnel.
". . . The practice by U.S. corporations of issuing Eurobonds through finance subsidiaries located in the Netherlands Antilles, rather than directly from the United States, is neither economical nor indicative of sound policy. . . . The current practice

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[1] Senate Comm. on Finance, Committee Print, Deficit Reduction Act of 1984, Explanation of Provisions Approved by the Committee on March 21, 1984, S. Prt. 98-169, Vol. I, 98th Congress, 2d Sess. 420 (1984).

imposes additional cost burdens on the issuing corporations and, in many cases, provides incomplete access to the Eurobond market."[2]

In 1985, after Congress repealed the 30% tax on portfolio interest received by foreigners on obligations issued after July 18, 1984, there was a surge in foreign investment in U.S. debt obligations. In 1984, foreign investors made net purchases of $11.9 billion of U.S. corporate bonds. In 1985, net purchases jumped to $39.8 billion. Foreign interest in U.S. corporate debt continued to climb in the following year. At the same time, interest rates in the U.S. were decreasing, with the average yield on an Aaa-rated long-term corporate bond dropping from 12.71% in 1984 to 11.37% in 1985. All other things remaining constant, in a declining interest rate environment, investors ordinarily would be expected to buy *less, not more*, corporate bonds. While no single factor accounts for the decision to invest, the repeal of the withholding tax was certainly one factor contributing to the increase in foreign investment in U.S. debt obligations.

Globalization, internationalization and the free flow of capital are key trends marking the 1980s. Foreign capital played a major role in helping to support the U.S. markets in the 1980s, thus bolstering sagging U.S. savings and investment rates and keeping interest rates lower than otherwise would have been the case. If anything, the fight to attract international capital has become more intense in the 1990s as emerging markets develop, closed economies open to foreign capital sources, and both the public and private sector seek to reduce the high interest rate debt assumed in the 1980s. The fierce competition for investment funds makes it highly undesirable for the U.S. to implement any policy that inherently discourages foreign investment without demonstrably compelling benefits.

In today's market environment, foreign investors' appetite for U.S. investment has waned from the 1980s. More international investment opportunities have come into play and interest rates are higher in many countries than in the U.S. Nevertheless, foreign investors remain an important source for financing domestic demand for funds. In 1991-92, foreign investors purchased $38.1 billion of U.S. corporate bonds. Moreover, net purchases of Treasuries by foreign institutions (other than central banks) in 1992 totaled $31.1 billion or about 11% of the 1992 federal deficit.

Recent data indicates that in the first three months of 1993, private foreign investors purchased $11.8 billion of Treasuries. Were this pace to continue, these foreign investors would be purchasers of about $47 billion of Treasuries in 1993, an amount equal to 16.5% of the $285.3 billion deficit estimated by the Administration for fiscal year 1993. This is significant considering the declining trend in U.S. interest rates.

Negative Effects of a Withholding Tax

Increased Costs to U.S. Corporations & Treasury

Debt obligations of U.S. issuers, burdened with a withholding tax, would have to compete with other securities sold outside the U.S. by non-U.S. issuers that are free of withholding tax. The net effect of the U.S. withholding tax, in most cases, would be to reduce the return to overseas investors on interest-bearing securities issued in the U.S. by up to 30%. This reduced return would make U.S. government and corporate obligations noncompetitive with alternative investments available in the Eurobond market. U.S. interest rates already are generally lower than in other countries at this time. By further eroding returns, a withholding tax would make U.S. obligations even less competitive in the global marketplace.

While it is theoretically possible to increase the yield to cover the withholding tax, this makes the costs of borrowing foreign capital considerably more expensive and unattractive to the U.S. issuers who will bear the additional cost. Larger and well-known companies could again turn to their foreign subsidiaries to issue debt in the Eurobond market, but smaller companies would have no such recourse. Moreover, unless Congress provided an exemption from the tax for Treasury, the proposed change could complicate its management of the U.S. federal debt.

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[2] S. Prt. No. 169, Vol. I, 98th Cong., 2d Sess. 420 (1984).

Impact on Domestic Interest Rates

If foreign investors will not purchase U.S. debt obligations at the current rate, U.S. issuers will have to satisfy their funding requirements from domestic sources. Although U.S. interest rates currently are at 20 and 30 year lows, the departure of the foreign investor because of the imposition of a withholding tax would certainly increase interest rates. Given the concerns over the current slow growth of the economy and lack of job creation, it would be foolhardy to risk an increase in interest rates that could blunt growth.

A Lower Dollar

A withholding tax acts as a tariff on the import of capital to the U.S. The foreign investor must first convert his currency to dollars which affects the international value of the dollar. He then must invest those dollars in U.S. corporations, effectively "importing" dollars into the U.S. Insofar as foreign investors choose not to invest in the U. S., the demand for dollars diminishes and the dollar weakens. Not only is the withholding tax a tariff, but it is a barrier as well. The incremental costs of borrowing that a 30% withholding tax creates makes it impractical for U.S. corporations to absorb that cost by increasing the rate of interest. On the other hand, foreign investors would surely buy less U.S. debt if the after-tax return were reduced by the amount of the withholding tax.

Impact on Other Countries

The U. S. has been the pioneer in deregulating capital markets and has encouraged its allies, particularly Japan, to do the same. Indeed, several other countries repealed their withholding taxes on interest in the wake of the U.S. repeal in 1984. Re-imposition of a withholding tax — regardless of size — sends the wrong message to the international community. It threatens to undo the positive effects of global capital market deregulation and invites retaliation.

More than 40 reciprocal income tax treaties exist between the U.S. and its trading partners. These treaties generally override the provisions of the U.S. Internal Revenue Code. Certain of these treaties provide for a zero rate of withholding on interest payments sourced in one of the two countries and paid to residents of the other. U.S. treaties with the United Kingdom, France, the Netherlands, and Germany, among others, provide for zero withholding on such payments. Regardless of the U.S. law, interest payments governed by zero withholding treaties will remain non-taxable in the U.S.

Where treaties with trading partners either do not exist or do not reduce the withholding tax to zero, a repeal of the portfolio interest exception will trigger a U.S. withholding tax on interest payments to residents of these countries. Such a levy will threaten economic cooperation, interfere with the flow of capital, and invite retaliation by our trading partners.

Even under the most optimistic scenario in which foreign countries do not impose new taxes and other retaliatory polices affecting capital flows, re-imposing a withholding tax will, at the very least, cause foreign nations to lose confidence in America's dependable and stable international financial policies.

Other Related Issues

Revenue Effects

Although interest payments represent a substantial portion of total payments to foreign persons, the revenue to be raised by re-imposition of a withholding tax would, in all likelihood, be negligible. Some foreign investors would simply terminate their U.S. investment and search out investments that are free of a withholding tax. More importantly, any estimated revenue gain is virtually certain to be outweighed by the negative revenue and economic implications of an increase in U.S. interest rates. If U.S. issuers gross-up their interest payments to foreigners and absorb the withholding tax, a larger corporate interest deduction is created. With pressure on domestic borrowing costs, Treasury's cost of capital can be expected to rise. Given the size of the Treasury's borrowing needs and the stable interest rate environment on which the 5-year deficit reduction plan rests, an increase in Treasury's cost of funds of even a few basis points could prove disastrous. The minimal revenues a withholding tax would garner are not worth increasing interest rates and jeopardizing deficit reduction.

Discrimination Against U.S. Investors

Some proponents of the withholding tax on interest payment made to foreigners suggest that the absence of such a tax discriminates against U. S. investors who are subject to the U.S. income tax on their interest and dividend income. However, this reflects a generally accepted principle of international taxation, *i.e.*, individuals should be subject to tax in their own country of residence. For example, only in certain select situations does the U.S. apply a capital gains tax to the gains of non-residents, though generally, U.S. residents are subject to the capital gains tax. Many foreign countries do not tax interest paid to non-residents at all.

The Mechanics of Compliance

Repeal of the portfolio interest exception would entail a plethora of compliance requirements and concerns, largely borne by financial intermediaries. To claim a treaty exemption or reduction, the foreign person will have to provide the U.S. payor with IRS Form 1001 for each issue on which interest is paid. The U.S. withholding agent (the payor) must retain the form for at least four years, increasing the record keeping burden already placed on payors. Payors will have to maintain a data base with sufficient information to determine the appropriate withholding rates. Collection and remittance of taxes to the federal government will likewise require additional paperwork and filings. To assure proper compliance, each payor will certainly have to incur significant expense to revamp its systems network and storage capabilities.

Summary

SIA urges Congress to reject legislation to re-impose, after 10 years, a withholding tax on interest payments to foreign investors. There are many serious negative implications and the potential benefits appear dubious at best. Continued and broad access to foreign capital is of vital importance to this nation's financial health.

TESTIMONY OF UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

As a supplement to our submission of September 20, 1993 regarding the proposals under consideration at the hearing of the House Ways and Means Select Revenue Measures Subcommittee on September 21, 1993, we would like to add our views on a third proposal, i.e., the proposal to reinstate nonresident withholding on certain portfolio interest.

Under current law, a 30 percent withholding tax is imposed on certain U.S. source interest income receive by foreign persons. In 1984, however, Congress exempted "portfolio interest" from U.S. tax. In enacting this exemption, Congress recognized that the 30 percent withholding tax impaired the ability of U.S. corporations to access international capital markets which increased their borrowing costs. The exemption allows U.S. borrowers to borrow more efficiently and, thus, at lower interest costs.

Reinstating the withholding tax on portfolio interest would increase interest rates for all U.S. borrowers, including the United States Government. This was most recently evidenced by the dramatic upswing in the interest rate on the 30-year U.S. Treasury bonds caused by the mere possibility that the withholding tax would be reinstated.

The U.S. Council for International Business strongly opposes the repeal of the portfolio interest exemption. It would inevitably lead to an immediate escalation in U.S. interest rates, a result which would create additional strains on our economy at a time when it is struggling to emerge from the recent recession.

93-23

SUBMITTED STATEMENT OF ROBERT E. LUCORE, RESEARCH ASSOCIATE,
ON BEHALF OF THE
AMERICAN FEDERATION OF LABOR AND
CONGRESS OF INDUSTRIAL ORGANIZATIONS
TO THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES,
HOUSE COMMITTEE ON WAYS AND MEANS
ON A PROPOSAL TO
CHANGE THE FOREIGN TAX CREDIT TO A DEDUCTION

September 21, 1993

I. INTRODUCTION

The AFL-CIO appreciates this opportunity to express its views on the proposal to change the foreign tax credit to a deduction. We have been in favor of this proposal for at least two decades, and are pleased that it is currently under consideration by this committee.

For the AFL-CIO the proposal is a simple matter of jobs and tax fairness. At a time when the nation faces high rates of unemployment, huge trade deficits, and increasing difficulty in raising the revenues necessary to address urgent needs, the foreign tax credit is indefensible. It amounts to a subsidy, paid for by the U.S. tax payers, that encourages U.S. based multinational corporations to export jobs and production overseas. Changing the foreign tax credit to a deduction would mean that foreign taxes paid by U.S. based companies would be treated in the same manner as state taxes.

II. THE SIMPLE ECONOMICS OF THE FOREIGN TAX CREDIT

A simple example may best explain why the foreign tax credit should be changed to a deduction. The table below provides an illustration.

EXAMPLES OF THE FOREIGN TAX CREDIT
(For a profit of $100,000)

COUNTRY/STATE	FOREIGN/STATE TAX RATE	FOREIGN/STATE TAX PAID	U.S. FEDERAL TAX PAID
U.S. - IOWA	10%	$10,000	$31,500
IRELAND	10%	10,000	25,000
SPAIN	35%	35,000	0
JAPAN	50%	50,000	0*

*In this case, the hypothetical firm will have excess credits of $15,000, which could be carried back, or forward, or used to offset the taxes due for profits from another country, such as Ireland.

Suppose a corporation makes a profit of $100,000 in the state of Iowa and is taxed at the statutory rate of 10 percent.[1] If we deduct the 10 percent paid in Iowa, the firm's taxable income at the federal level is $90,000. Let us suppose that the firm pays its federal taxes at the 35 percent rate established under the new budget. The result will be $31,500 in federal revenues (35 percent of 90,000). This illustrates what occurs when taxes are treated as a cost of doing business and are deducted.

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[1] Advisory Committee on Intergovernmental Relations, Significant Features of Fiscal Federalism, Vol. 1, Washington, D.C., February, 1991, Table 25, p. 72.

Now change the scenario and assume that the firm is doing business in Ireland, but is based in the U.S. Suppose that it is taxed at the Irish statutory rate of 10 percent.[2] The U.S. federal taxes on its $100,000 income would be $35,000 before applying the credit (35 percent of 100,000). But, when $10,000 in tax credits are applied, tax revenues received by the U.S. drop to $25,000 ($35,000 minus $10,000).

Suppose the corporation makes income of $100,000 in Spain, where the tax rate is 35 percent. In this case it pays $35,000 to the Spanish government and zero dollars to the U.S. treasury when the foreign tax credit is applied.

Finally examine the case where the corporation is gaining income from business in a country with higher tax rates than the U.S. In Japan, the corporation pays almost 50 percent or $50,000 in income taxes. Applying the $50,000 in foreign tax credits to the before-credit U.S. taxes of $35,000 once again means that the U.S. treasury receives zero revenue. However, that may not be the end of the story. The corporation is able (subject to certain limitations) to apply the excess credits of $15,000 ($50,000 in tax credits from Japan minus $35,000 credited toward U.S. taxes) to taxes due on income from other, low tax, countries. The corporation can also carry the excess credits back up to two years, or forward up to five years to offset taxes on income earned earlier or later.

III. TAX FAIRNESS

To American families, whose federal taxes are, for the most part, withheld from their paychecks at an average effective rate of 23 percent,[3] the foreign tax credit loophole is astonishing. A study published this year by the National Bureau of Economic Research shows that this astonishment is justified. The authors find that a sample of 340 U.S. parent corporations had foreign-source income of $47.3 billion and paid U.S. taxes on that income of only $1.6 billion. Thus the effective U.S. tax rate on foreign source income was 3.4 percent. In the manufacturing sector, which accounted for 90 percent of the foreign source income, corporations paid only 2.3 percent in taxes.[4]

The AFL-CIO supports the simple principle of tax fairness which says that equal incomes should be treated equally. The foreign tax credit violates this principle by granting privileged status to income earned abroad. At a time when both the federal government and the state governments are being squeezed by inadequate revenues, it amounts to a form of "revenue sharing" between the U.S. treasury and various foreign treasuries.

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[2] The source for the statutory rates used in this example is: Price Waterhouse, Corporate Taxes: a Worldwide Summary, New York, 1990, as cited in David L. Brumbaugh, U.S. Taxation of Overseas Investment: Selected Issues in the 102d Congress, CRS Report for Congress, September 16, 1991. It should be noted that many companies are granted tax holidays and are therefore able to pay effective rates of 0 percent in Ireland.

[3] See Committee on Ways and Means, U.S. House of Representatives, Overview of the Federal Tax System, June 14, 1993, table 16, page 342.

[4] Rosanne Altshuler and T. Scott Newlon, "The Effects of U.S. Tax Policy on the Income Repatriation Patterns of U.S. Multinational Corporations," in Alberto Giovannini, R. Glenn Hubbard, and Joel Slemrod, Studies in International Taxation, A National Bureau of Economic Research Project Report, Chicago: University of Chicago Press, 1993, Table 3.2, p. 91. These figures are for 1986, the latest available when the authors performed their analysis.

IV. REVENUE CONSIDERATIONS

For 1990 (the latest figure available), U.S. based multinational corporations used foreign tax credits to reduce their income tax bills by $25 billion. Because the tax rate in effect at that time was 34 percent, treating the credit as a deduction would have raised an additional $16.5 billion in revenue.[5]

Surely the Congress can find more appropriate ways to spend $16.5 billion dollars other than subsidizing the foreign operations of U.S. based corporations. President Clinton's stimulus program, defeated by filibuster, comes to mind as an example.

V. EXPORTING JOBS

Working Americans are increasingly concerned about the export of jobs to overseas locations. Nearly one million manufacturing jobs have been lost in the U.S. since January of 1991. The accumulated foreign trade deficit over this same period was $208 billion. The two are linked, an estimated 25,000 jobs are lost for every $1 billion increase in the trade deficit.

The foreign tax credit contributes to this process by providing a back-door subsidy from the U.S. treasury for foreign production compared with domestic production. While changing the tax credit to a deduction would not solve all of the nations's trade and competitiveness problems, it would at least remove a major government subsidy for exporting production and jobs.

VI. ANSWERING THE CRITICS

Critics will argue that changing the credit to a deduction will cause other governments to "retaliate" by removing foreign tax credits that they offer to their companies that are doing business in the United States. They will characterize this proposal as a beggar-thy-neighbor policy.

What these critics are saying is that the U.S. cannot stop subsidizing overseas business, or foreign governments will stop subsidizing foreign subsidiaries operating in the U.S. The AFL-CIO sees no reason why any nation should be required to provide subsidies to production occurring beyond its borders.

The foreign tax credit, in effect, turns over the taxing authority of the U.S. government to foreign governments. It says, in a sense, that if a foreign government chooses to tax a corporation, the U.S. will not, and if the foreign government increases the taxes it collects from the corporation, the U.S. will reduce its tax collections in response.

VII. OTHER RELEVANT ISSUES

Of course the foreign tax credit is not the only multinational tax issue that concerns American workers and their unions. The AFL-CIO is also concerned about such issues as the deferral process and the abuse of transfer prices. We would be happy to share our thoughts on these matters with the committee at some future date.

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[5] AFL-CIO Economic Research Department calculations based on data reported in Internal Revenue Service, SOI Bulletin, Summer 1993, table 13, p. 127.

VIII. CONCLUSION

We support the concept of changing the foreign tax credit to a deduction. It would eliminate a subsidy that contributes to the export of U.S. jobs and production. It would add to federal revenues. It would move the U.S. system of international taxation closer to the principle of tax fairness.

Removing the privileged status that income earned by U.S. multinationals abroad now enjoys should not be viewed as a protectionist move, or as an unfair effort to raise revenue at the expense of business. Rather, it is a matter of closing a loophole and treating equal incomes equally.

Testimony of

Andre P. Fogarasi,
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and

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Before the Select Revenues Subcommittee Of
The Ways and Means Committee of
The United States House of Representatives

For Hearings on
Miscellaneous Revenue Provisions

September 23, 1993

Introduction

We are grateful for the opportunity to provide the Subcommittee our comments on a proposal to replace the tax credit for foreign income taxes with a tax deduction. This proposal, by imposing double taxation on U.S. enterprises doing business abroad, would have a sweeping and devastating impact on the worldwide business and political interests of the United States. It would force U.S. citizens and businesses to turn inward in an increasingly international economy. In short, the proposal amounts to economic isolationism.

To show this more clearly, we have summarized below four broad lines of argument against this proposal. We believe any one of these arguments is reason to dismiss the proposal. Given the preponderance of evidence and arguments against this proposal, we believe this proposal is not worthy of further consideration by this Subcommittee.

Example

Before making our policy arguments, we will illustrate the impact of this proposal with a simple example:

> *Facts:* Suppose a U.S. business generates $1 million in income in the United States and $1 million of income in Europe, and suppose the corporate tax rate here and abroad is 35 percent. The total worldwide tax is $700,000 ($350,000 U.S. plus $350,000 Europe) or 35 percent of worldwide income.
>
>> *Under Present Law.* The $2 million of worldwide income generated by the U.S. business would be subject to $700,000 in U.S. corporate income tax. However, this U.S. tax would be reduced by the $350,000 of taxes paid to European tax authorities. U.S. income tax net of the foreign tax credit is $350,000. The total worldwide tax is 35 percent of worldwide income, or $700,000 ($350,000 of U.S. tax and $350,000 in European tax).
>>
>> *Under the Proposal to Eliminate Foreign Tax Credit.* The same U.S. business would still be subject to $350,000 of foreign income tax. For U.S. purposes, however, worldwide taxable income would now be equal to $2 million reduced by $350,000, or $1.65 million. This amount subject to a 35 percent rate would result in U.S. tax of $577,500. The total worldwide tax burden would be $927,500 ($577,500 U.S. plus $350,000) or 46.4 percent.
>
> This amounts to an increase of $227,500 of U.S. tax on $1 million of foreign source income. Thus, *the effective rate of tax on income earned in overseas markets increases from 35 percent to approximately 58 percent.*

The impact of this proposal on each particular business will vary largely depending on the average rate of foreign tax on foreign source income.[1] As shown in the short appendix to our testimony, if a business is subject to a foreign tax rate of 25 percent, its effective tax rate on foreign source income will increase from 35 percent to approximately 51 percent. And if a business is subject to a foreign tax rate of 45 percent, its effective tax rate on foreign source income will increase from 45 percent to approximately 64 percent. Of course, U.S. tax law is far more complicated than we have portrayed it, but for a proposal as sweeping as this one, the details hardly matter.

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[1] In 1988, U.S. corporations reported $31.7 billion of foreign taxes on $99.9 billion of foreign source income. Thus, the average effective foreign tax rate in 1988 is approximately 32 percent. See, Karla M. Daronco and Kimberly A. Veletto, "Corporate Foreign Tax Credit, 1988: An Industry Focus," Statistics of Income Bulletin, Summer 1992, Internal Revenue Service, Washington, D.C., Table 1, p. 86.

Brief Overview

Present law grants U.S. taxpayers a credit against U.S. income taxes for income taxes paid to a foreign government. Present law also contains a limitation so that the foreign tax credit only offsets U.S. tax on foreign income. Thus, the U.S. tax base on U.S. source income is well protected. Special rules have been added over the years where Congress perceived special problems.[2] Congress has, from time-to-time, denied the foreign tax credit for taxes paid to a particular foreign country, but only where seeking to provide a severe disincentive to investment in that country. For example, Congress denied a credit for taxes paid to a country designated by the Secretary of State as "repeatedly" supporting "acts of intentional terrorism,"[3] and, at one time, consistent with the Comprehensive Anti-Apartheid Act, taxes paid to South Africa.[4]

Four Policy Arguments Against the Proposal

With this background, we now proceed with our policy arguments.

(1) Replacing the foreign tax credit with a deduction for foreign taxes would unfairly and unjustifiably subject U.S. citizens and corporations based in the United States to double taxation on all income earned abroad.

Fairness is a fundamental goal of the income tax, and this proposal is patently unfair. The proposal would result in discriminatory taxation of income earned overseas. For example, a U.S. citizen who works part-time in Canada and part-time in the United States would pay more tax on his Canadian income than would be paid by either a U.S. citizen who works solely inside in the United States or by a Canadian citizen who works solely inside Canada. The only reason for this penalty is that work has taken the individual across a national border.

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[2] See, for example, §§901(f) and 907 which provide special rules for foreign oil and gas income, and §901(e) which provides special rules for foreign taxes on mineral income.

[3] §901(j)(2)(iv).

[4] §901(j)(2)(c).

Over the years, this Subcommittee and the Full Committee have heard numerous complaints that a particular provision of current law or a particular proposal to change current law causes double taxation. What distinguishes this proposal from these other situations is its scope. This is not an isolated instance where technical features of the law have resulted in double taxation of a particular type of income under certain conditions. This proposal would systematically and intentionally subject all income earned abroad to two levels of tax.

(2) Replacing the foreign tax credit with a tax deduction would make the United States an outlaw among nations by violating long-established norms of international taxation.

The fundamental premise of the current international tax system is that income should not be taxed by more than one country. There are two general methods that governments use to achieve this. The first is a system of worldwide taxation with foreign tax credits. This is the system the U.S. employs and is described in the example above. Under this system, the home county only taxes income earned abroad to the extent (if any) that the home country's rate of tax exceeds the rate prevailing in the host country. The second system is the territorial system. Under the territorial system, the home government simply does not tax income earned abroad. Both these methods are entirely consistent with the long-standing international norms accepted by all developed countries and most developing countries that the primary right to tax is that of the host country. The home country for the residual right to tax.

If the United States adopted this proposal, it would no longer be ceding the primary right to tax business income to host countries. No other developed country does this. It would invite retaliation by foreign governments and unravel the basic order that has existed among nations on this issue. Avoidance of double taxation lies at the core of all U.S. tax treaties. Thus, this proposed change would violate the most fundamental principle of the U.S. treaty network.[5] The rule of primary taxation by host countries is one area where there has been remarkable harmony among nations and it has worked well--for both governments and taxpayers. This basic framework of the international system is not broke, and it does not need to be fixed.

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[5] Of course, the proposal could be limited so as to apply only to foreign taxes generated in non-treaty countries. This would be jumping out of the frying pan and into the fire. While now there are important tax advantages available under treaties, the same basic set of rules applies to investments in treaty and non-treaty countries. If the tax credit were only available for taxes of treaty countries, this would create an enormous disincentive to conducting business in non-treaty countries and the role of treaties in international tax policies would be overwhelming.

(3) Replacing the foreign tax credit with a tax deduction would have a devastating impact on U.S. corporations competing overseas.

In 1990 (the latest year for which published data is currently available), U.S. corporations used $25 billion in foreign tax credits.[6] Conversion of these credit to deductions would represent approximately a $16 billion annual increase in costs for U.S. business with operations abroad. In most cases, the effective tax on income generated abroad would exceed 50 percent, and in many cases the effective tax rate would exceed 60 percent.

Like the term "double taxation" discussed above, this Subcommittee and the Full Committee has listened to a great deal of testimony complaining how current law and certain provisions to amend it would hinder "competitiveness." We are aware there has been a lot of debate about what competitiveness means and how much taxes actual effect competitiveness. We are also aware that the term "competitiveness" has been used so often that its meaning has become diluted. In the context of this provision, however, we believe there is really no room for debate. Unequivocally, the competitiveness of the U.S. business would be undermined. U.S. businesses would not be able to compete in a foreign jurisdiction with companies from that jurisdiction or with multinational companies from other countries. The cost of maintaining a worldwide distribution network would escalate and U.S. exports would suffer. It is important to remember that this proposal would affect every business with operations abroad. Furthermore, with such a large and disruptive tax increase, the repercussions would reverberate throughout the economy beyond the businesses immediately effected.

That competitiveness must suffer can be seen by looking at the simple example above. Under present law a U.S. business attempting to operate in a country with a 35 percent tax rate pays a net tax, both U.S. and European country, of 35 percent. Under the proposal the net tax would increase to 58 percent, while our competitors would continue to pay a tax of 35 percent. Since taxes are a significant cost of doing business, and since the U.S.-based business's tax costs would be more than 50 percent greater than its non-U.S. competitor's, the U.S.-based company would become non-competitive.

(4) Eliminating the foreign tax credit and replacing it with a deduction violates universally accepted economic principles which endeavor to maximize economic growth by allowing the free flow of capital.

The economic debate surrounding international taxation has been largely bounded between two competing principles: capital export neutrality and capital import neutrality. Under capital export neutrality, income is taxed according to the rate in the residence of the investor. Under capital import neutrality, income is taxed according to the rate in the location of the investment. Thus, under capital export neutrality, if the rate of tax is 35 percent in the United States and 25 percent overseas, income from investments abroad would be taxed at 35 percent. Accordingly, taxes would be equal regardless of whether a U.S. business invested at home or abroad. Under capital import neutrality, income from investments abroad would be taxed at 25 percent, and a U.S. company would be taxed at the same rate as its overseas competitors'.

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[6] Nina Shumofsky, "Corporations, 1990," Statistics of Income Bulletin, Internal Revenue Service, Washington D.C., Table 2, p. 41.

Current U.S. law is a mixture. For example, when U.S. tax law allows deferred recognition of income generated abroad it provides a regime which is a mixture between capital export neutrality and capital import neutrality. It is less generous than pure capital import neutrality because eventually U.S. tax will be paid to the extent the U.S. tax rate exceeds the foreign tax rate. It is more generous than capital export neutrality because any excess of U.S. over foreign tax is deferred. The recent expansion of anti deferral rules in the Omnibus Reconciliation Action of 1993 represented a move for some firms further away from capital import neutrality and closer to capital export neutrality.

The proposal in question would violate both capital import neutrality and capital export neutrality, and would thus provide one of those rare occasions when all economists would be in agreement. In the example above capital export neutrality resulted in a tax rate of 35 percent. Capital import neutrality would result in a tax rate of 25 percent. Replacing the foreign tax credit with a tax deduction would result in a tax rate on foreign income always in excess of the U.S. rate and in most cases (as noted above) in excess of 50 percent. Thus, a U.S. business would be subject to a substantially greater tax burden on its operations abroad than on its domestic operations. Furthermore, income from its overseas operations would be taxed at a substantially higher rate than income generated by foreign competitors'.

Conclusion

Elimination of the foreign tax credit would have enormous and negative implications for the U.S. role in the international marketplace. In one fell swoop, this provision would upset a well-functioning system of international cooperation that has evolved over many decades. It would unquestionably make U.S. businesses uncompetitive and result in large and inefficient distortions to the flow of international capital and trade. We believe it should not be endorsed in any way by this Subcommittee.

Appendix --Additional Examples of the Effect of Elimination of the Foreign Tax Credit

***Example A.1.* Foreign rate in excess of the U.S. tax rate.**

> *Present Law.* Suppose A U.S. business generates $1 million in income in the United States and $1 million of income in Europe, and suppose the corporate tax rate here is 35 percent and the foreign rate is 45 percent. The $1 million of income generated abroad would be subject to $450,000 of tax. The $2 million of worldwide income generated by the U.S. business would be subject to $700,000 in U.S. corporate income tax. However, this U.S. tax would be reduced by only $350,000 of the $450,000 of taxes paid to European tax authorities. U.S. income tax net of the foreign tax credit is $350,000.
>
> *Proposal to Eliminate Foreign Tax Credit.* The same U.S. business would still be subject to $450,000 of foreign income tax. For U.S. purposes, however, worldwide taxable income would now be equal to $2 million reduced by $450,000, or $1.55 million. This amount subject to a 35 percent rate would result in U.S. tax of $507,500.

This is an increase in U.S. tax of $257,500. The effective rate of tax on income earned in overseas market would increase from 45 percent to approximately 64 percent.

***Example A.2.* Foreign rate is below the U.S. tax rate.**

> *Present Law.* Suppose A U.S. business generates $1 million in income in the United States and $1 million of income in Europe, and suppose the corporate tax rate here is 35 percent and the foreign rate is 25 percent. The $1 million of income generated abroad would be subject to $250,000 of tax. The $2 million of worldwide income generated by the U.S. business would be subject to $700,000 in U.S. corporate income tax. However, this U.S. tax would be reduced by the $250,000 of taxes paid to European tax authorities. U.S. income tax net of the foreign tax credit is $450,000.

> *Proposal to Eliminate Foreign Tax Credit.* The same U.S. business would still be subject to $250,000 of foreign income tax. For U.S. purposes, however, worldwide taxable income would now be equal to $2 million reduced by $250,000, or $1.75 million. This amount subject to a 35 percent rate would result in U.S. tax of $612,500.

This is an increase in U.S. tax of $162,500. The effective rate of tax on income earned in overseas market would increase from 45 percent to approximately 51 percent.

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August 19, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

I am writing in response to your request for comments on the potential revenue-raisers to be considered by the Subcommittee on Select Revenue Measures in September. One idea, in particular, has the potential to raise billions of dollars in tax revenues, while simultaneously simplifying the taw laws and their administration, although it is probably the most controversial item on your list. I am referring, of course, to the proposed repeal of Internal Revenue Code Section 901 - the foreign tax credit.

As you know, income taxes paid to foreign jurisdictions, including Canadian provinces and Swiss cantons that are the functional equivalent of our states, can be subtracted, dollar for dollar, from a U.S. taxpayer's Federal income tax liability, subject to some increasingly complicated rules and regulations. This means, in many cases, that the income tax cost of doing business in a foreign jurisdiction is born by the U.S. Treasury, rather than the taxpayer. Two theories support this strange result:

(1) It is necessary to avoid double taxation of the same income.

(2) It is necessary to keep American business competitive overseas.

The first argument ignores the fact that double, or even triple, taxation is an inherent feature of our tax system, particularly since the repeal of the General Utilities doctrine, so it is difficult to see why foreign income taxes alone should be exempt from this result. Moreover, the averaging mechanisms permitted by existing law often force the U.S. Treasury, and hence the U.S. taxpayer, to subsidize foreign tax rates that are well in excess of the U.S. statutory rates. By treating foreign income taxes the same as any other deductible business expense, such as state income taxes, and state, Federal and foreign excise taxes, Congress could eliminate this anomaly, vitiate thousands of pages of tedious rules and regulations dealing with the computation of foreign source income and deductions, and encourage tax professionals to focus more of their ample tax planning skills on **foreign** tax collectors.

The second argument has greater rhetorical force, but it ignores the fact that many thriving international businesses do not need the foreign tax credit to remain competitive. For example, those companies that manufacture their products in the U.S. and export them overseas generally pay no foreign income taxes. It is only the businesses that **manufacture** overseas that subject themselves to foreign income taxes. Of course, the repeal of the foreign tax credit would not prevent them from continuing to do so, but they would now have to weigh the foreign income tax, like any other business expense, in their decision as to where they manufacture.

If it is not feasible to repeal Section 901 at this time, the Committee may wish to consider some partial measures that would still raise significant revenues and help to wean taxpayers away from the foreign tax credit to help facilitate a future repeal:

(1) The Alternative Minimum Tax might be computed with only a deduction for foreign income taxes, even where the Section 901 credit is claimed in the regular tax computation. This would be consistent with Congress's 1986 decision to limit the AMT foreign tax credit to 90% of the AMT liability.

(2) The foreign tax credit might be limited to the lesser of $1,000,000 or 50% of the U.S. tax liability before credits.

I doubt that you will receive many other letters in support of this particular proposal, but I have no doubt that the lobbying to defeat this proposal, if it is considered seriously, will provide lots of gainful employment for my brethren in the tax bar. In any case, I wish you and the Committee well in your deliberations.

Sincerely yours,

Jim Ditkoff

James H. Ditkoff

The Association of British Insurers

The Association of British Insurers ("ABI") is a U.K. trade association which represents more than 450 U.K. insurance companies which write both insurance and reinsurance for property/casualty and life risks[1]. Together these companies (excluding their overseas subsidiaries) write 90% of the premiums written by U.K. insurance companies, and nearly 70% of all insurance premiums written in the U.K. (the remainder of premiums written in the U.K. are written by syndicates at Lloyd's of London and non-member companies).

International insurance is written in the "London Market", the distinctive international market renowned for its coverage of novel and hard-to-place risks on a co-insurance basis (many companies accepting small fractions of the total liability under a policy). In 1990, this market accounted for premiums of approximately £10.25 billion ($19.75 billion). Approximately 25% of this was believed to be U.S. business ($5 billion), divided roughly equally between reinsurance and direct insurance[2]. In addition, U.K. companies provide reinsurance to their U.S. subsidiaries.

Proposed Amendment of the Excise Tax on Insurance Placed Abroad

The proposed amendment to the excise tax on insurance placed abroad would increase the rate on property/casualty reinsurance from one per cent to four per cent. However, it would allow a rate reduction from four to one per cent if three conditions are satisfied:

> (1) the reinsurer is a resident of the foreign country,
>
> (2) the foreign country taxes insurance income (including investment income) at an effective rate that is "substantial" in relation to the U.S. income tax, and
>
> (3) the risk is not reinsured (directly or indirectly) with a reinsurer resident in a country that does not tax such insurance income at a substantial effective rate (the "anti-conduit rule).[3]

Reasons for Opposition

Despite the announced intention of directing the rate increase toward reinsurers in "tax haven" countries, the amendment would impose a tax on U.K. reinsurers in violation of the U.S.-U.K. tax treaty. It would also impose costly and inappropriate administrative burdens upon U.K. insurers, and would inevitably result in cost increases to U.S. insurance companies and U.S. policyholders. The added compliance requirements would surely deter some smaller companies from writing U.S. business, and would impair the ability of the London Market to provide coverage for catastrophes and hard-to-place lines of business.

International Insurance Coverage Provided by U.K. Insurers

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[1] This material is issued and circulated by Hopkins & Sutter, 888 16th Street, N.W., Washington, D.C. 20006, which is registered under the Foreign Agents Registration Act as an agent of the Association of British Insurers, 51 Gresham Street, London EC2V 7HQ, U.K. This material is filed with the Department of Justice where the required registration statement is available for public inspection. Registration does not indicate approval of the contents of the material by the United States Government.

[2] Source: Operation and Regulation of the London Insurance Market, prepared by the London Insurance and Reinsurance Market Association, 1992.

[3] See, "Description of Miscellaneous Revenue Proposals", prepared by the Joint Committee on Taxation for the Select Revenue Measures Subcommittee of the House Ways and Means Committee, September 16, 1993 (JCS-12-93).

U.S. insurance companies and policyholders have relied upon the London insurance market (the "London Market") for more than 100 years to provide coverage of risks for which coverage was typically unavailable in the United States. This major international insurance market is distinct from the market for risks within the U.K., which provides coverage for personal lines (automobile and homeowners) and small commercial risks.

The London Market has become the world's premier international insurance market because of its history of service, capacity, innovation, affordability, and financial stability. It is renowned for its coverage of large commercial insureds and entities with special or hard-to-place coverages. It is the world center for marine and aviation war risks. It highly regarded for specialist underwriting skills in general marine hull and aviation business, as well as for coverage of energy business, such as drilling rigs in Texas and the Gulf of Mexico.

The London Market's unique reputation has not been built on underwriting capacity alone. U.K. insurers are widely recognized for their innovative approaches to the needs of major policyholders and insurance companies in the U.S.. In recent years, technical skills in product design and rating have enabled U.K. insurers to develop coverage for satellites and other high technology products. Historically, it has pioneered the development of coverages such as worker's compensation and earthquake.

London is one of the principal foreign reinsurance markets for U.S. companies. It has been widely recognized for its ability to provide catastrophe coverage, and is a significant source of reinsurance capacity for U.S. reinsurers, as well as primary companies. The U.K. is one of the primary reinsurers of small local insurers writing crop hail insurance in the farming regions of the U.S.. U.K. insurers provide medical malpractice reinsurance protection for both insurers and self-insured medical entities. Historically, the London Market has been a source of capacity when United States markets have constricted. A major example occurred during the "liability crisis" of 1984-86, when U.K. insurers dramatically increased their underwriting of U.S. business, thereby providing the necessary capacity to enable U.S. insurers to meet the needs of U.S. policyholders. In both the mid-1970's and mid-1980's, London has provided medical malpractice reinsurance and claims made policy coverage to major buyers when alternate sources of reinsurance were not available within the U.S..

Since 1988, the London Market has paid billions of dollars in response to such disasters as Hurricanes Andrew and Iniki, the Piper Alpha North Sea Oil Rig Explosion[4], Hurricane Gilbert, Exxon Valdez, Hurricane Hugo[5], San Francisco (Loma Prieta) Earthquake, and the Phillips Petroleum Explosion. Foreign reinsurers are expected to provide payments covering approximately forty percent of the $16 billion claims under Hurricane Andrew, the largest single disaster in U.S. history. Payments on other disasters have been estimated[6] to be:

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[4] An analysis of the claims resulting from the explosion of the mainly American owned Piper Alpha oil rig in the North Sea in 1988 concluded that, after reinsurance recoveries, only 5% of the aggregate claims cost was paid by American insurers and reinsurers, while 80% of the aggregate claims cost was paid by London Market insurers. Mercantile & General Reinsurance Co., Piper Alpha: the Insurance and Reinsurance Aspects (London: Mercantile & General Reinsurance Co., 1988).

[5] A 1986 study of the potential impact of two major hurricanes striking the U.S. Gulf and Atlantic coasts causing total insured losses of $14 billion concluded that 42.4% of the total claims would be paid by foreign non-admitted reinsurers. All-Industry Research Council, Catastrophic Losses: How the Insurance System Would Handle Two $7 Billion Hurricanes, (Washington, D.C.: All-Industry Research Council, 1986).

[6] Source: Operation and Regulation of the London Insurance Market, prepared by the London Insurance and Reinsurance Market Association, 1992.

	Catastrophe	U.K. Insurers Losses
1.	Piper Alpha North Sea Oil Rig Explosion (7/6/88)	Excess of $1 billion
2.	Exxon Valdez (3/25/89)	Excess of $500 million
3.	Hurricane Hugo (10/17 & 22/89)	Approximately $4 billion
4.	Loma Prieta Earthquake (10/17/89)	Excess of $1 billion
5.	Phillips Petroleum Explosion (10/23/89)	Excess of $1 billion

The London Market has been able to underwrite and satisfy such huge losses because of the distinctive practice of writing insurance and reinsurance on a "co-insurance" basis. Under this approach, a single policy is presented to a lead underwriter (a U.K. company or syndicate at Lloyd's of London) by a U.K. broker, who answers questions about the risk until the lead underwriter has sufficient information to decide whether to provide coverage and at what level to set the premium. The lead underwriter may take less than five per cent of the risk, and numerous other underwriters take much smaller amounts of the overall liability, typically one or two per cent. Co-insurance of risks significantly reduces the liability for any one company on a policy and enables U.K. insurance companies to write catastrophe coverages and other volatile lines which domestic markets have generally proven unwilling to accept. However, U.K. insurers routinely purchase reinsurance to reduce the risk of unprofitable business or insolvency even further.

Domestic reinsurers have not demonstrated that the 1986 tax increases upon property-casualty insurers have placed them at a competitive disadvantage. On the contrary, recent difficulties in obtaining catastrophe reinsurance as a result of Hurricanes Andrew and Iniki and other catastrophes have illustrated again the importance of foreign reinsurance to the U.S. market when domestic coverage becomes unavailable or very costly. This conclusion is supported by a study of reinsurance placed with U.K. reinsurers. In U.S. Insurance and Reinsurance Transactions with Insurers Resident Abroad, prepared by Professor Robert L. Carter, O.B.E.,in January, 1992, and based upon data provided by the U.S. Department of Commerce, Professor Carter found

> "the available evidence indicates that in the main U.K. reinsurers, including Lloyd's of London, do not compete against American professional reinsurance companies for U.S. reinsurance business. They act as suppliers of reinsurance to American primary insurers, and reinsurers, for large individual and catastrophe-type risks, and for difficult to place risks. In both 1989 and 1990, following the hurricanes Gilbert and Hugo, the San Francisco earthquake, and the Pasadena gas explosion, U.S. insurance companies' total dollar loss recoveries from U.K. reinsurers exceeded the amounts they paid to them in reinsurance premiums."

Contravention of the U.K. Treaty

The U.K. treaty contained the first waiver of the insurance excise tax. In return, the treaty provided the U.S. significant benefits, most noticeably, rights to payment of the tax credit on dividends paid by a U.K. corporation, whose value to U.S. companies dwarfs that of the FET waiver to U.K. insurers. The waiver of the excise tax ("FET") in the U.S.-U.K. treaty, and in four other treaties (U.S.S.R., Hungary, Romania, and Malta), is ***absolute and unconditional***[7]. The provision is in contrast to the waivers in the French, German and later treaties, which provide that the treaty waiver is denied to the extent that the foreign insurer reinsures the U.S. risk with reinsurers in non-treaty countries.

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[7] Art. 7(6A) of the U.S.-U.K. tax treaty provides

> The United States tax on insurance premiums paid to foreign insurers shall not be imposed on insurance or reinsurance premiums which are the receipts of a business of insurance carried on by an enterprise of the United Kingdom whether or not that business is carried on through a permanent establishment in the United States.

The bill would alter the long-standing interpretation of the treaty in three ways:

> 1) It would impose a "tax haven" anti-conduit rule, which would condition reduction of the rate from four per cent to one per cent on the absence of reinsurance with non-qualified reinsurer, i.e. under the bill's definition, one not having a "substantial" income tax in relation to the tax imposed by the U.S.;
>
> 2) It would require foreign companies to obtain closing agreements to qualify for exemption, while the current law provides for withholding by the last U.S. person making the premium payment, but encourages closing agreements with foreign companies to relieve U.S. payors of liability;
>
> 3) As drafted, the statute would require even a company that qualified for the rate reduction to pay a one per cent rate rather than the zero rate negotiated by the U.S. in treaty waivers — a unilateral override that affects all treaties containing waivers.

U.K. Government views treaty waiver as unconditional

The U.K. government is firmly of the view that the U.S.-U.K. treaty precludes any tax on subsequent reinsurance of U.S. risks. In a letter on June 5, 1992, only days after the introduction of the Rostenkowski/Gradison bill, U.K. Ambassador Renwick informed Treasury Secretary Brady,

> the [treaty] exemption from FET was a total and unconditional one and any restriction of that unqualified exemption is a treaty matter.

In a letter of July 2, 1992, after a similar provision was added to the Comprehensive Energy Act, H.R. 776, by Senator Breaux, the Ambassador wrote Senate Finance Committee Chairman Bentsen, and stated,

> When the UK/US Tax Treaty was agreed, as part of the negotiations UK companies were granted total exemption from Federal Excise Tax in return for treaty benefits enjoyed by U.S. companies operating in Britain. The taxation of UK insurers in the twelve years since the treaty was signed has been consistent with such a general exemption. Any restriction of the exemption in our view would affect the terms of the treaty.

In addition, the Inland Revenue's solicitor has formally opined that the treaty waiver is absolute and unconditional.

A unilateral amendment of the treaty would disrupt relations with a major treaty partner, which is one of the most important sources of high-quality reinsurance for U.S. companies. The departure from long-established interpretations of the waiver in the U.S.-U.K. treaty would violate international comity and impair the Treasury's ability to negotiate future treaties. In a 1989 interview, then International Tax Counsel Leonard Terr commented,

> " I think there is no question that overrides damage the treaty program in the sense that they make it more difficult to negotiate treaties. ***They damage our credibility, diminish the confidence of our treaty partners in U.S. commitments, and erode the certainty and stability in bilateral fiscal and commercial relations which a tax treaty is supposed to promote and ensure.***"[8]

The protests from the British government reflect just the sort of "damage to [U.S.] credibility" that Mr. Terr feared. Quite simply, the U.S. cannot selectively override a single provision of the treaty and expect to preserve all other benefits that it receives under the treaty.

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[8] Interview with Leonard Terr, Tax Notes, January 9, 1989, p. 159.

No Evidence of Treaty Abuse

Congressional inquiries have been made about the absence of an anti-conduit rule in the British treaty almost from the time of ratification. Although there have been repeated expressions of concern about the hypothetical possibility that the treaty might be used for the creation of such conduits, there has been no evidence of actual treaty abuse. The facts are just the opposite. In reply to questions raised about possible use of British insurers to "front" for non-qualified companies in the Deficit Reduction Act of 1984, the U.K. government submitted a Note to the Treasury Department that reviewed the regulatory restraints and economic factors which discourage fronting for non-qualified third country reinsurers. The U.K. government concluded, "we can find no evidence to support the assertion that a significant amount of 'fronting' is undertaken by UK insurers to avoid FET."[9]

In the absence of evidence of treaty abuse, it is inappropriate to propose an amendment of the treaty, by unilateral Congressional action, twelve years after the treaty's ratification, which would restructure the waiver provision to require tracing of reinsurance placements. The U.K. government is firmly of the view that such a measure would violate the unconditional waiver in the treaty.

Finally, the ABI notes that the U.K is just the sort of high tax jurisdiction for which the waiver was intended, in order to create economic parity and to avoid double taxation. Taxation of U.K. insurance companies is high, and certainly comparable to that of U.S. insurance companies. Accordingly, it would not be sound tax policy to delete waivers of the excise tax from the Model Treaty, as the Reinsurance Association of America (the sole supporter of the amendment) has advocated in its written statement. Indeed, such a move would be contrary to the recommendations of the 1990 Treasury study.[10]

Conclusion

U.K. insurance companies have long been an important source of high quality reinsurance for U.S. insurance companies. While U.S. companies would unquestionably prefer to buy from domestic companies rather than non-admitted foreign reinsurers, U.S. insurers have turned to the London Market because of its unique reputation for service, capacity, innovation, affordability, and financial stability. In certain lines such as medical malpractice, energy, earthquake and environmental coverage, it has provided capacity when coverage from U.S. reinsurers has been unavailable. It has also provided a major source for catastrophe reinsurance and has paid extraordinary claims for the San Francisco Earthquake, Hurricane Hugo, the Phillips Petroleum explosion, and the Exxon Valdez.

The rate increase and three part test in the proposed amendment would contravene the unconditional waiver of the FET in the U.S.-U.K. tax treaty in three respects: (1) by imposing an anti-conduit rule in clear contravention of the absolute waiver of the FET in the treaty, (2) by requiring foreign companies to obtain closing agreements before permitting a reduction or waiver of the tax, and (3) by maintaining a one per cent rate, even after satisfaction of the new three-part test, in contravention of the zero rate in the treaty. The British Government has protested the violation of the treaty provision.

The new taxes imposed on British insurers would increase the pressure for higher premiums to U.S. insurance and reinsurance companies. These increased costs would necessarily be passed along to U.S. consumers. In the current economic climate, there is no justification for increasing insurance costs to consumers. Moreover, compliance costs would deter smaller companies now writing reinsurance on a co-insurance basis. Their withdrawal would inevitably reduce the capacity available to U.S. companies. Because of the adverse economic effects created by the proposal, it has been opposed by a broad coalition, including all trade associations representing U.S. primary insurance companies, as well as representatives of brokers and risk managers.

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[9] Letter from M.R.H. Jenkins, Minister, British Embassy, to Treasury Secretary James A. Baker, III, November 13, 1985.

[10] *See*, Report to Congress on the Effect on U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums, U.S. Department of Treasury, (March, 1990).

The Congress should not adopt an amendment which would cause material disruption of relationships with a major treaty partner.

We urge the Subcommittee not to adopt the amendment.

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September 21, 1993

VIA MESSENGER

Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means, U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Further Hearings on Miscellaneous Revenue Measures by Subcommittee on Select Revenue Measures -- Proposed Increase in Excise Tax on Reinsurance Premiums -- Group Captive Insurance Companies Subject to Subpart F

Dear Ms. Mays:

In connection with the Subcommittee's consideration of miscellaneous revenue measures on September 21, we submit the following comments and recommendations as counsel to the Attorneys' Liability Assurance Society, Inc.

One of the proposed measures set for hearing on September 21 would increase the excise tax on reinsurance premiums paid to certain foreign persons. This provision is ill-advised, for the reasons discussed below. It is also technically flawed in failing to exempt captive insurance companies, the earnings of which are subject to current U.S. taxation under subpart F.

BACKGROUND

Section 4371 of the Internal Revenue Code imposes an excise tax on insurance premiums paid to foreign insurers and reinsurers. The tax on casualty insurance premiums is four percent; the tax on casualty reinsurance premiums is one percent.

In addition, the Tax Reform Act of 1986 added a special subpart F provision that subjects the income of offshore group captive insurance companies to current taxation to their stockholders. Section 953(c) classifies as subpart F insurance income the income attributable to premiums paid to a captive foreign insurer by its U.S. stockholders. This provision applies if U.S. stockholders own at least 25 percent of the foreign insurer and their premiums constitute at least 20 percent of the insurer's insurance income.

The proposed revenue measure would generally increase from one to four percent the excise tax on reinsurance premiums paid to foreign insurers. A similar provision was contained in H.R. 5270, at section 303. The intent is to tax premiums paid to tax haven reinsurers. Therefore, section 303 excepted from the increased tax reinsurance premiums paid to a foreign insurer that are subject to an effective rate of tax *by a foreign country* that is substantial in relation to the tax imposed by the United States. The Joint Committee explanation of the provision stated that an effective rate of tax equal to 50 percent of the applicable U.S. rate will generally be considered substantial.

SUMMARY OF POSITION

An increase in the reinsurance excise tax is unwarranted, possibly inconsistent with existing income tax treaties, and likely to lead to retaliation by trading partners. It is also inconsistent with current GATT negotiations with regard to services.

In addition, in exempting premiums subject to high foreign tax, the proposed increase provision fails to exempt premiums paid to foreign captive insurers whose insurance income is already fully subject to U.S. taxation under subpart F. By imposing a double tax, the provision as drafted discriminates against captive insurance companies.

Finally, the purpose of the special subpart F provision for captive insurance companies expired in 1990 with the provision in the United States-Bermuda income tax treaty that exempted Bermuda insurance companies from the excise tax. Retention of the current structure is unfair and discriminates against captive insurance companies by subjecting them to both the excise tax and subpart F. Therefore, Congress should consider repealing the subpart F provision.

DISCUSSION

1. The proposed increase in the FET is unsound.

a. It constitutes an unjustified and dangerous increase in a tariff on financial services.

The foreign reinsurance excise tax is, in economic substance, a tariff on the importation of insurance services. It amounts to a domestic subsidy for the U.S. reinsurance industry, its only advocate. There is no evidence that U.S. reinsurers, which are already quite profitable, are in need of any such additional protection.

In fact, an increase in the tax would result in substantial increases in insurance costs for most U.S. insureds. U.S. insurers as a matter of course reinsure all or part of the risks they insure, with both domestic and foreign reinsurers. Much or all of the proposed tax increase would be passed through to consumers of insurance services in the United States.

In addition to the increased tax cost of foreign reinsurance, domestic reinsurers can be expected to increase rates, given the protection provided by the tax. This increased cost of casualty insurance would come at a particularly bad time for U.S. insureds, which are already experiencing increased rates as a result of recent catastrophic losses such as Hurricane Andrew and the Midwest flooding.

b. The increase would cause particular harm to certain U.S. businesses that cannot obtain reinsurance domestically.

Many businesses with extraordinary risks that are hard to quantify have found it difficult or impossible to obtain insurance or reinsurance domestically. This problem has given rise to the formation of association captive insurers, which deal almost exclusively in long-tail, high-risk commercial lines. Examples include the medical, legal, engineering, architectural, and accounting professions, the nuclear power industry, the petroleum industry, product liability of high-risk products such as aircraft, pharmaceuticals, chemicals and construction equipment, directors and officers ("D&O") coverage of financial institutions, and hospitals. Offshore companies, like the reinsurance affiliate of ALAS, were formed because U.S. companies fail to provide coverage.

Underwriters abandon the marketplace in various ways. They may refuse to write the risk entirely, as in the case of nuclear, environmental, and some product liability risks. They may also refuse to provide coverage limits as high as needed, as in the case of medical, engineering, accounting, and legal professional liability risks. Underwriters may also broaden exclusions to the point that coverage is ineffectual; D&O coverage of commercial banks and S&Ls are two examples. And they may impose selective and arbitrary underwriting standards that eliminate coverage of individual insureds, categories of insureds, or geographical areas, an example being the reluctance of domestic carriers to provide meaningful D&O coverage to most banks in the Northeast and Southwest, and S&Ls in various areas.

The complexity of today's economy requires that the cost of indemnifying victims of catastrophic risks be widely spread. Unless it is, there is insufficient funding to compensate victims, or to keep the responsible company, or even an industry, viable. It is the association captives that have been created over the last ten to fifteen years that have provided many categories of essential coverage as U.S. commercial carriers withdrew from writing high-risk lines.

Because coverage is unavailable in the United States, the entire burden of the tax increase would be borne by these particular U.S. businesses. The proposed increase in the excise tax would impose substantial additional insurance costs on such insureds.

c. An increase in the FET would interfere with global trade negotiations and would harm U.S. exports of financial services.

An increase in tax on imported insurance services would also run contrary to the efforts of the United States to expand the General Agreement on Tariffs and Trade to include services, including financial services. The U.S. Trade Representative has said that our trading partners would regard an increase in the reinsurance excise tax as "an impediment to trade in this service [and] significantly damage the efforts of the United States to open the global insurance markets to U.S. companies in the Uruguay Round of services negotiations."

The expansion of GATT to services is important to the international competitiveness of U.S. service industries. Without GATT protection, the U.S. insurance industry will be effectively barred from entering many potential foreign markets. Other U.S. service industries are similarly affected.

d. The tax in not administrable and violates the terms of U.S. treaties.

Our treaty partners, the United Kingdom in particular, regard the increase provision in H.R. 5270 as a violation of U.S. treaty obligations. The tax, as formulated, would fall not only on contracts of reinsurance with U.S. companies, but also on any subsequent cessions of any part of the risk to third parties in other countries. Some treaties do not contain any limitations with regard to cessions.

Furthermore, it is difficult or impossible in most cases to trace cessions of reinsurance to any particular risk, at least until a loss occurs. The Treasury Department opposed the provision in H.R. 5270 because of the problems of administering the tax.

2. *Subpart F captives would be taxed twice.*

The intent of section 303 of H.R. 5270 was to limit the increase in the rate of the reinsurance tax to premiums paid to tax haven insurers, which otherwise might not be subject to any tax, either foreign or U.S. Thus, the provision exempted from the increase any insurer subject to foreign tax on U.S. premium income that is substantial in relation to U.S. tax.

Income attributable to reinsurance premiums paid by U.S. stockholders to offshore captive companies are generally subject to current U.S. income taxation. The income of an offshore captive insurer from its U.S. stockholder premiums are fully taxed on a current basis to its U.S. stockholders under subpart F. If offshore insurers subject to high foreign tax are exempted from the increase, surely those subject to current U.S. tax under subpart F ought also to be exempt.

In its testimony on the Bermuda treaty, Treasury testified that the special subpart F provision eliminated any tax policy concern that might be addressed by the excise tax. Statement of the Honorable J. Roger Mentz to the Senate Foreign Relations Committee 4 (Sep. 25, 1986). Treasury stated a similar conclusion in its Report to Congress on the Effect on U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums at 3 (March 1990). The Report recommended that U.S. shareholders be given a credit for the excise tax, in order to avoid double-taxation of insurance income.

And finally, in his testimony before the Ways and Means Committee on July 21, 1992, Assistant Treasury Secretary Goldberg stated that, if the reinsurance tax were increased, it should be amended to take account of the subpart F provision. He said,

> the rate at which the FET should be imposed is an issue of competitive balance. We are not convinced that a general rate increase is warranted at this time. *However, if the rate is increased, the provision should be amended to take into account any current U.S. taxation of U.S. shareholders under subpart F.*

Statement of Fred T. Goldberg Before the Committee on Ways and Means 26 (Jul. 21, 1992)(emphasis added).

3. *The captive insurance company rules no longer serve their intended purpose.*

Section 953(c), the special subpart F provision for captive insurance companies, was enacted in response to the tax treaty signed with Bermuda in 1986. The Bermuda treaty would have waived the U.S. excise tax on insurance and reinsurance premiums. Congress was concerned that the U.S. premium income paid to captive insurers might consequently be escape tax anywhere. In a letter to the Secretary of the Treasury of July 15, 1986, the Chairman of the Ways and Means Committee stated the perceived problem with the Bermuda treaty as follows:

> The proposal would bless U.S.-owned Bermuda insurance companies, which, in some cases, through the use of spread captive devices, now may be avoiding all tax other than the excise tax on income earned by insuring U.S. risks. In addition, the U.S. premium payors may be deducting the premiums from U.S. taxable income. Thus, the proposed treaty, by exempting these insurance premiums from U.S. tax, would eliminate not double taxation but any taxation.

The special subpart F provision was therefore enacted to provide current U.S. taxation of that U.S.-source insurance income in lieu of the excise tax.

When the Bermuda treaty was subsequently considered for ratification, the Senate reserved on the excise tax waiver. Under the reservation, the waiver expired on January 1, 1990. This was done despite the fact that Congress's concern that Bermuda captives would escape tax was addressed by the special subpart F provision. U.S.-source insurance income of a Bermuda-based captive insurer is therefore now subject to both the excise tax and to current subpart F taxation.

In sum, the subpart F provisions for captive insurance companies arose out of concern that Bermuda companies would be subject to no United States tax. The excise tax exemption of the Bermuda treaty expired in 1990. Therefore, the justification for subjecting captive insurance companies to subpart F no longer exists. Retaining the current subpart F provision is unfair to captive insurance companies because other classes of offshore insurance companies incur only excise tax liability on their U.S. premium income. Congress should therefore consider elimination of the special captive insurance company provisions of subpart F.

CONCLUSIONS AND PROPOSAL

The proposed increase in the excise tax is unwarranted and possibly harmful to the international trade interests of the United States. It should not be enacted.

At the very least, if the increase is adopted, the exemption ought to be expanded to include premiums paid to captive insurers subject to the special subpart F provision. That provision already fully addresses the concern that related-party insurance income might escape taxation.

Finally, the special subpart F provision for captive insurance companies can now be repealed. The provision is inconsistent simultaneous application of the excise tax, which has followed sunset of the Bermuda treaty waiver. It also is now inconsistent with its purpose, as indicated by the Ways and Means Chairman's letter. The proposed increase only exacerbates the situation and further discriminates against U.S.-owned captives formed to provide coverage for U.S. insureds for which coverage was not available in the United States.

Very truly yours,

John E. Chapoton
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BARBARA B. KENNELLY
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Congress of the United States
House of Representatives
Washington, DC 20515

September 17, 1993

The Honorable Charles Rangel
Chairman
Subcommittee On Select Revenue Measures
1105 Longworth House Office Building
Washington, D.C. 20515

Dear ~~Chairman Rangel~~: Charlie

I would greatly appreciate it if you could see fit to include the attached letters in the hearing record of the Select Revenue Subcommittee hearing on Tuesday, September 21, 1993.

The first letter is a letter to Chairman Rostenkowski signed by 22 Members of the Ways and Means Committee outlining opposition to the proposal to increase the Federal excise tax on reinsurance premiums paid to foreign reinsurers of U.S. property casualty risks. There are also a number of letters from state insurance commissioners in opposition to the proposal.

Thank you.

Sincerely,

Barbara
BARBARA B. KENNELLY
Member of Congress

BBK:pk

THIS STATIONERY PRINTED ON PAPER MADE OF RECYCLED FIBERS

Congress of the United States
Washington, DC 20515

April 28, 1993

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
U.S. House of Representatives
Room 1102 Longworth Building
Washington, D.C. 20515

Dear Mr. Chairman:

We are writing to express our serious concerns and strong opposition to any effort to increase the Federal excise tax (FET) on reinsurance premiums paid to foreign reinsurers of U.S. property/casualty risks. We understand an amendment of that nature may be offered during the upcoming markup of the budget reconciliation bill.

We oppose increasing the FET on foreign reinsurance for several reasons. Most seriously, it would restrict the reinsurance available to U.S. companies and would increase the cost of insurance in the United States. If the FET is increased, the domestic cost of reinsuring products and services -- such as health care and natural disasters -- will rise correspondingly. Furthermore, the burden of increased reinsurance costs will be passed onto the U.S. insurance industry and, ultimately, to American businesses and consumers.

Foreign reinsurance markets provide critical capacity for the U.S. insurance market. Over 40 percent of the $16.5 billion liability coverage in Hurricane Andrew was reinsured by foreign reinsurers. They are a primary source of reinsurance protection against catastrophic property damage. They also are significant markets for many volatile lines, such as medical malpractice, lawyers' malpractice, municipal liability and environmental liability protection. Foreign reinsurers have supplemented the U.S. market capacity or been the sole source of reinsurance protection in many other ways, as well.

We know you share our concerns, Mr. Chairman, for secure and reliable reinsurance markets. Undoubtedly, any increase in the FET on foreign reinsurance premiums will reduce competition within the U.S. reinsurance market, restrict reinsurance capacity, increase insurance costs to American consumers and invite retaliation from foreign governments and treaty partners against U.S. insurers operating abroad.

We respectfully urge you, Mr. Chairman, to join us in opposing any attempt to increase the Federal excise tax on foreign reinsurance premiums. Clearly, the Committee should not legislate on this important issue without adequate consideration of these objections and without the benefit of public hearing at which all interested parties, including the new Administration, are given an opportunity to be heard.

Thank you for consideration of this matter.

Sincerely,

Barbara B. Kennelly
Barbara Kennelly

Jim McDermott
Jim McDermott

E. Clay Shaw, Jr.
Clay Shaw

Wally Herger
Wally Herger

William J. Coyne
William J. Coyne

Bill Thomas
Bill Thomas

Nancy L. Johnson
Nancy Johnson

Harold Ford
Harold Ford

Mel Hancock
Mel Hancock

Phil Crane
Phil Crane

Sandy Levin
Sandy Levin

Don Sundquist
Don Sundquist

John Lewis
John Lewis

Peter Hoagland.
Peter Hoagland

Dave Camp
Dave Camp

Rick Santorum
Rick Santorum

Amo Houghton
Amo Houghton

Richard E Neal
Richard Neal

Jim McCrery
Jim McCrery

Jim Bunning
Jim Bunning

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Fred Grandy

Robert T Matsui
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SALVATORE R. CURIALE
SUPERINTENDENT OF INSURANCE

May 12, 1993

The Honorable Alfonse D'Amato
United States Senate
Washington, DC 20510

Dear Senator D'Amato:

The American Insurance Association (AIA) informs me that Congress may reintroduce a provision to raise the federal excise tax (FET) on reinsurance premiums paid to non-U.S. reinsurers for U.S. property/casualty risks from the current 1% to 4%, which was contained in last year's Foreign Income Tax Rationalization and Simplification Act (H.R. 5270).

The AIA opposes increasing the FET and I concur with both its position and its rationale, as detailed in the attached document. This tax would have adverse effects upon the cost and availability of insurance in my state. Further, because of its discriminatory nature, it could adversely affect U.S. insurers doing business abroad.

I request that you bring these arguments to the attention of Chairman Rostenkowski and any others in Congress who may pursue an increase in the FET this year.

Thank you for your attention to this important issue.

Sincerely,

Salvatore R. Curiale
Superintendent of Insurance

OFFICE OF THE TREASURER
DEPARTMENT OF INSURANCE
TOM GALLAGHER
TREASURER

May 6, 1993

Post-It™ brand fax transmittal memo 7671	# of pages ▸ 2
To George Henry	From Dick Dorsey
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Dept.	Phone #
Fax #	Fax #

The Honorable Robert Graham
United States Senate
Washington, DC 20510

RE: Reinsurance Excise Tax

Dear Senator Graham:

The Foreign Income Tax Rationalization and Simplification Act of 1992 (H.R. 5270) contained a proposal to raise from 1 percent to 4 percent the federal excise tax (FET) on reinsurance premiums paid to non-U.S. reinsurers for U.S. property casualty risks. The rate could be reduced to 1 percent if the foreign reinsurer satisfied all parts of a complex three part test. The bill was introduced for discussion purposes, but not passed in the last Congress. I understand that it (or at least the FET provision of the bill) is likely to be reintroduced this year.

As a state insurance regulator, I oppose increasing the tax on foreign reinsurance for several reasons. Most importantly, it could restrict the reinsurance available to U.S. companies and/or increase the cost of insurance in the United States. If the FET is increased, the domestic costs of products and services reinsured -- like health care and hurricane - will rise correspondingly. The burden of increased reinsurance costs will be passed on to the U.S. insurance industry and, ultimately, to American business and consumers.

Foreign reinsurance markets provide critical capacity for the U.S. insurance market. They are a primary source of property catastrophe reinsurance protection, which is essential for U.S. insurers to provide homeowners insurance, and other property protections, to residents of this state. They are also a significant market for many volatile lines, such as medical malpractice, lawyers malpractice, municipal liability and environmental liability protections. There are many other examples where foreign reinsurers have supplemented the U.S. market capacity, or been the sole source, of reinsurance protections.

Hurricane Andrew is the most recent example of the importance of the foreign reinsurance market. Approximately $3 billion will be recovered from non-U.S. reinsurers to help pay for Andrew's losses. Moreover, in the wake of Hurricane Andrew, the property insurance market in the United States and the catastrophe reinsurance markets worldwide are poised for significant cost increases and a reduction in capacity.

Now, more than at any recent time, state insurance regulators are concerned about secure and reliable reinsurance markets. The international reinsurance market is important to our state. Undoubtedly, an increase in the federal excise tax on foreign reinsurance premiums will restrict the capacity, resulting in the higher costs being passed on to consumers and/or invite retaliation from foreign governments against U.S. insurers operating abroad. I would appreciate your assistance in bringing these facts to the attention of Chairman Rostenkowski and others in Congress who may pursue the FET increase this year.

Sincerely,

Tom Gallagher
Treasurer and
Insurance Commissioner

TREASURER / INSURANCE COMMISSIONER / FIRE MARSHAL

STATE OF ARIZONA
DEPARTMENT OF INSURANCE

FIFE SYMINGTON
Governor

ABACUS TOWER
3030 NORTH 3RD STREET, SUITE 1100
PHOENIX, ARIZONA 85012

SUSAN GALLINGER
Director of Insurance

May 16, 1993

The Honorable John McCain
United States Senator
United States Senate
Washington, DC 20510

RE: Reinsurance Excise Tax

Dear Senator McCain:

The Foreign Income Tax Rationalization and Simplification Act of 1992 (H.R. 5270) contained a proposal to raise from 1 percent to 4 percent the federal excise tax (FET) on reinsurance premiums paid to non-U.S. reinsurers for U.S. property casualty risks. The rate could be reduced to 1 percent if the foreign reinsurer satisfied all parts of a complex three part test. The bill was introduced for discussion purposes, but not passed in the last Congress. I understand that it (or at least the FET provision of the bill) is likely to be reintroduced this year.

As a State Insurance regulator, I am concerned about increasing the tax on foreign reinsurance for several reasons. First, the increased tax could restrict the reinsurance available to U.S. insurers and/or increase the cost of insurance in the United States. If the FET is increased, the domestic costs of products and services reinsured - such as health care and hurricane protection - will rise correspondingly. The increased reinsurance costs will be passed on to U.S. insurance industry and, ultimately to businesses and consumers throughout the U.S.A.

Foreign reinsurance markets provide critical capacity for the U.S. insurance market. They are a primary source of property catastrophe reinsurance protection, which is essential for U.S. insurers to provide homeowners insurance, and other property protections, to residents of Arizona. They are also a significant market for many volatile lines, such as medical malpractice, lawyers malpractice, municipal liability and environmental liability protections. There are many other examples where foreign reinsurers have supplemented the U.S. market capacity, or been the sole

Hurricane Andrew is the most recent example of the importance of the foreign reinsurance market. Approximately $3 billion will be recovered from non-U.S. reinsurers to help pay for Andrew's losses. Moreover, in the wake of Hurricane Andrew, the property insurance market in the United States and the catastrophe reinsurance markets worldwide are poised for significant cost increases and a reduction in capacity.

Now more than at any recent time, State insurance regulators are concerned about secure and reliable reinsurance markets. The international reinsurance market is important to Arizona. An increase in the federal excise tax on foreign reinsurance premiums will restrict capacity, result in the higher costs being passed on to consumers and/or invite retaliation from foreign governments against U.S. insurance companies operating abroad.

I would very much appreciate your assistance in bringing these facts to the attention of Chairman Rostenkowski and others in Congress who may pursue the FET this year.

Sincerely,

Susan Gallinger
Director of Insurance

SG/k

STATE OF
IOWA

David J. Lyons, Commissioner

TERRY E. BRANSTAD, GOVERNOR

INSURANCE DIVISION
IOWA DEPARTMENT OF COMMERCE

June 2, 1993

The Honorable Charles E. Grassley
United States Senator
135 Hart Senate Office Building
Washington, D.C. 20510-3744

RECEIVED
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EXEC. DEPT.

RE: Reinsurance Excise Tax

Dear Senator Grassley:

The Foreign Income Tax Rationalization and Simplification Act of 1992 (H.R. 5270) contained a proposal to raise from 1 percent to 4 percent the federal excise tax (FET) on reinsurance premiums paid to non-U.S. reinsurers for U.S. property casualty risks. The rate could be reduced to 1 percent if the foreign reinsurer satisfied all parts of a complex three part test. The bill was introduced for discussion purposes, but not passed in the last Congress. I understand that it (or at least the FET provision of the bill) is likely to be reintroduced this year.

Although I support all efforts for tax equity and agree with the idea of discussing this subject, as a state insurance regulator, I am presently concerned with increasing the tax on foreign reinsurance for several reasons. Most importantly, it could restrict the reinsurance available to U.S. companies and/or increase the cost of insurance in the United States. If the FET is increased, the domestic costs of products and services reinsured -- like health care and hurricane -- will rise correspondingly. These are two areas in particular where the development of U.S. reforms should perhaps be done first, so as not to exacerbate the cost problems consumers presently face. The burden of increased reinsurance costs will be passed on to U.S. insurance industry and, ultimately to American business and consumers at a very difficult time.

Foreign reinsurance markets provide critical capacity for the U.S. insurance market these days. They are a primary source of property catastrophe reinsurance protection, which is essential for U.S. insurers to provide homeowners insurance, and other property protections, to residents of this state and to states with severe problems, like Florida. They are also a significant market for many volatile lines, such as medical malpractice, lawyers malpractice, municipal liability and environmental liability protections. There are many other examples where foreign reinsurers have supplemented the U.S. market capacity, or been the sole source, of reinsurance protections.

Hurricane Andrew is the most recent example of the importance of the foreign reinsurance market. Approximately $3 billion will be recovered from non-U.S. reinsurers to help pay for Andrew's losses. Moreover, in the wake of Hurricane Andrew, the property insurance market in the United States and the catastrophe reinsurance markets worldwide are poised for significant cost increases and a reduction in capacity.

Now, more than at any recent time, I am concerned about secure and reliable reinsurance markets. The international reinsurance market is important to our state. An increase in the federal excise tax on foreign reinsurance premiums this year could restrict capacity, result in the higher costs being passed on to consumers and/or invite retaliation from foreign governments against U.S. insurers operating abroad. I would appreciate your assistance in bringing these facts to the attention of Chairman Rostenkowski and others in Congress who may pursue the FET increase this year.

Sincerely,

David J. Lyons
Commissioner of Insurance

DJL/nem

cc: Loren Fligg

THE COMMONWEALTH OF MASSACHUSETTS
EXECUTIVE OFFICE OF CONSUMER AFFAIRS
DIVISION OF INSURANCE
280 FRIEND STREET, BOSTON, 02114
(617) 727-7189

GLORIA C. LARSON
SECRETARY

KAY DOUGHTY
COMMISSIONER

June 7, 1993

The Honorable John Kerry
United States Senate
Washington, D.C. 20510

Dear Senator Kerry:

The Foreign Income Tax Rationalization and Simplification Act of 1992 (H.R. 5270) contained a proposal to raise from 1 percent to 4 percent the federal excise tax (FET) on reinsurance premiums paid to non-U.S. reinsurers for U.S. property casualty risks. The rate could be reduced to 1 percent if the foreign reinsurer satisfied all parts of a complex three part test. The bill was introduced for discussion purposes, but not passed in the last Congress. I understand that it (or at least the FET provision of the bill) is likely to be reintroduced this year.

As a state insurance regulator, I oppose increasing the tax on foreign reinsurance for several reasons. Most importantly, it could restrict the reinsurance available to U.S. companies and/or increase the cost of insurance in the United States. If the FET is increased, the domestic costs of products and services reinsured -- like health care and hurricanes -- will rise correspondingly. The burden of increased reinsurance costs will be passed on to the U.S. insurance industry and, ultimately to American business and consumers.

Foreign reinsurance markets provide critical capacity for the U.S. insurance market. They are a primary source of property catastrophe reinsurance protection, which is essential for U.S. insurers to provide homeowners insurance, and other property protections, to residents of this state. They are also a significant market for many volatile lines, such as medical malpractice, lawyers malpractice, municipal liability and enviromental liability protections. There are many other examples where foreign reinsurers have supplemented the U.S. market capacity, or been the sole source, of reinsurance protections.

property insurance market in the United States and the catastrophe reinsurance markets worldwide are poised for significant cost increases and a reduction in capacity.

Now, more than at any recent time, state insurance regulators are concerned about secure and reliable reinsurance markets. The international reinsurance market is important to our state. Undoubtedly, an increase in the federal excise tax on foreign reinsurance premiums will restrict capacity, result in the higher costs being passed on to consumers and/or invite retaliation from foreign governments against U.S. insurers operating abroad. I would appreciate your assistance in bringing these facts to the attention of Chairman Rostenkowski and others in Congress who may pursue the FET increase this year.

Sincerely,

Kay Doughty

Kay Doughty
Commissioner of Insurance

KD:emb

[Identical letter to Hon. Edward M. Kennedy]

ARKANSAS
INSURANCE
DEPARTMENT

400 University Tower Building
1123 South University Ave.
Little Rock, Arkansas 72204

501-686-2900

Lee Douglass
Insurance Commissioner

March 30, 1993

The Honorable David Pryor
United States Senate
Russell Senate Office Building
Room 267
Washington, D.C. 20510

RE: Reinsurance Excise Tax

Dear Senator Pryor:

The Foreign Income Tax Rationalization and Simplification Act of 1992 (H.R. 5270) contained a proposal to raise from 1 percent to 4 percent the federal excise tax (FET) on reinsurance premiums paid to non-U.S. reinsurers for U.S. property casualty risks. The rate could be reduced to 1 percent if the foreign reinsurer satisfied all parts of a complex three part test. The bill was introduced for discussion purposes, but not passed in the last Congress. I understand that it (or at least the FET provision of the bill) is likely to be reintroduced this year.

As a state insurance regulator, I oppose increasing the tax on foreign reinsurance for several reasons. Most importantly, it could restrict the reinsurance available to the U.S. companies and/or increase the cost of insurance in the United States. If the FET is increased, the domestic costs of products and services reinsured -- like health care and hurricane -- will rise correspondingly. The burden of increased reinsurance costs will be passed on to U.S. insurance industry and, ultimately to American business and consumers.

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Hurricane Andrew is the most recent example of the importance of the foreign reinsurance market. Approximately $3 billion will be recovered from non-U.S. reinsurers to help pay for Andrew's losses. Moreover, the wake of Hurricane Andrew, the property insurance market in the United States and the catastrophe reinsurance markets worldwide are poised for significant cost increases and a reduction in capacity.

Now, more than at any recent time, state insurance regulators are concerned about secure and reliable reinsurance markets. The international reinsurance market is important to our state. Undoubtedly, an increase in the federal excise tax on foreign reinsurance premiums will restrict capacity, result in the higher costs being passed on to consumers and/or invite retaliation from foreign governments against U.S. insurers operating abroad. I would appreciate your assistance in bringing these facts to the attention of Chairman Rostenkowski and others in Congress who may pursue the FET increase this year.

Sincerely,

Lee Douglass
Insurance Commissioner

LD:sy

NAIB NATIONAL ASSOCIATION OF INSURANCE BROKERS
1401 New York Avenue, N.W. ▪ Suite 720 ▪ Washington, D.C 20005 ▪ Phone (202) 628-6700 ▪ Fax (202) 628-6707

September 23, 1992
BY MESSENGER

The Hon. Charles Rangel
Chairman
Select Revenue Measures Subcommittee
Ways and Means Committee
1105 Longworth House Office Building
Washington, DC 20515

RE: COMMENT FOR THE SEPTEMBER 21, 1993, HEARING RECORD; NAIB OPPOSES INCREASE IN THE FEDERAL EXCISE TAX ON REINSURANCE

Dear Mr. Chairman:

The NAIB is the trade association of commercial insurance brokers. Our members are insurance experts who represent the interests of insurance consumers in the marketplace and administer the majority of all commercial insurance placed in the United States.

We are writing to oppose the proposed increase in the federal excise tax on reinsurance from the current one percent to four percent, because the tax is protectionist, it will increase insurance costs to consumers, and it undermines U.S.-negotiated tax treaties.

We believe the proposed FET increase is protectionist, contradicts U.S. efforts to open up world markets and eliminate barriers to trade in services. It could also invite retaliation by foreign governments at a time when U.S. underwriters are seeking to expand their sales in Europe and around the globe.

Our trading partners do not impose any such tax on risks ceded to U.S. reinsurers. Those U.S. reinsurers who support the tax increase argue that it will create a level playing field, because U.S. reinsurers are more heavily taxed than their foreign competitors. However, studies by the Treasury Department (1990) and General Accounting Office (1989) could not verify this claim. It is inappropriate to penalize foreign insurance markets for some perceived inequity in the U.S. tax code.

Generally speaking, the FET is passed on to insurance buyers so any increase in the FET will increase insurance costs for consumers.

Insurance markets are global in nature, and U.S. reinsurers must rely on overseas reinsurers to assume a portion of their risks. There is not enough coverage available from U.S. reinsurers to meet the needs of U.S. insurers. Higher costs for reinsurance overseas will be passed on to buyers as higher premium rates. A price increase that can only be explained as protection for U.S. reinsurers against overseas competition cannot be justified.

The FET increase will undermine the value of U.S.-negotiated tax treaties and invite retaliation by trading partners. The proposed increase would override FET waivers in current tax treaties. This override amounts to unilateral abrogation of U.S. treaty obligations that were negotiated to benefit both countries.

In summary, because the proposed FET increase is protectionist, cannot be verified as needed to offset similar foreign taxes, will raise the cost of insurance to consumers, and undermines existing U.S. tax treaties and our ability to negotiate new treaties, we urge you to oppose this tax.

Sincerely,

Michael J Hass

Michael J. Hass, Chairman
NAIB Tax Committee

Statement By The

REINSURANCE ASSOCIATION OF AMERICA

SUBCOMMITTEE ON SELECT REVENUE MEASURES

COMMITTEE ON WAYS AND MEANS

U.S. HOUSE OF REPRESENTATIVES

Hearings on

MISCELLANEOUS REVENUE-RAISING PROVISIONS

This statement is submitted by the Reinsurance Association of America ("RAA") for inclusion in the record of the hearings on Miscellaneous Revenue-Raising Provisions held by the Subcommittee on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives. The RAA is a voluntary trade association comprised of 26 professional property and casualty reinsurance companies, all of which are subject to direct regulation by the states in which they are licensed or admitted to do business, and are subject to U.S. income tax.[1] The RAA's members derive nearly all of their premium income from the reinsurance of risks located in the United States.

The RAA believes that the U.S. income and excise tax laws must be coordinated to prevent unintended competitive advantages for foreign companies reinsuring risks originating in the United States. The RAA fully supports the provision incorporated by reference from H.R. 5270 for these hearings which is intended to level the playing field with respect to domestic reinsurers and those located in countries which do not impose a substantial amount of income tax on U.S. risk reinsurance transactions.

The United States currently imposes an excise tax equivalent to four percent (4%) of gross premium on direct property and casualty insurance business written by non-admitted (referred to herein as "non-resident") foreign insurance companies and one percent (1%) on reinsurance premiums assumed by those companies. However, in a number of international income tax treaties, the United States has agreed to waive the collection of insurance excise taxes. Among those countries benefiting from income tax treaties are some of the United States' most important trading partners, including France, Italy, Spain, the United Kingdom, and Germany. Additional treaty waivers of the excise tax have been agreed to with Cypress, Hungary, Malta, Romania, India, and Finland. The United States also granted treaty waivers of the excise tax to Barbados and Bermuda, countries which do not tax U.S. risk reinsurance transactions. These treaty waivers, however, were statutorily eliminated at the end of 1989.

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[1] The RAA's members are: American Re-Insurance Company; American Royal Reinsurance Company; AXA Reinsurance Company; Chartwell Reinsurance Company; Christiania General Insurance Company of New York; CIGNA Reinsurance Company; Constitution Reinsurance Corporation; Employers Reinsurance Corporation; General Reinsurance Corporation; General Security Assurance Corporation; Gerling Global Reinsurance Corporation; Mercantile & General Reinsurance Company of America; Munich American Reinsurance Company; NAC Reinsurance Corporation; National Reinsurance Corporation; North American Reinsurance Corporation; North Star Reinsurance Corporation; PMA Reinsurance Corporation; Prudential Reinsurance Corporation; Reinsurance Corporation of New York; San Francisco Reinsurance Company; Scor Reinsurance Company; Skandia America Reinsurance Corporation; Trenwick America Reinsurance Corporation; Underwriters Reinsurance Company; and, Winterthur Reinsurance Corporation.

With the enactment of the Tax Reform Act of 1986 (the "1986 Act"), insurance companies subject to U.S. income tax on a net basis ("resident insurers") were placed at a distinct competitive disadvantage vis-a-vis non-resident insurers and reinsurers. While by no means the only provision in the 1986 Act to affect the taxation of resident insurers and reinsurers, the loss reserve discount rule substantially increased the operational costs of resident reinsurers without any effect at all on foreign reinsurers which are not subject to U.S. income tax on a net basis ("non-resident reinsurers"). Although the one percent (1%) federal excise tax levied on the gross amount of reinsurance premiums ceded abroad historically has been intended to ameliorate to some extent the lack of U.S. income tax being imposed on this reinsurance, after the 1986 Act the one percent (1%) level of tax simply is not high enough to assure competitive equilibrium between resident and non-resident reinsurers, particularly non-resident reinsurers operating out of tax-haven countries. Exacerbating this problem has been the Treasury Department's liberal granting of treaty waivers of the excise tax.

To counteract the increased federal income tax burden imposed on domestic insurers and reinsurers as a result of the 1986 Act, the RAA supports an increase in the federal excise tax on property/casualty reinsurance premiums ceded abroad. Although it falls somewhat short of the RAA's preferred reform of the excise tax scheme, the subject provision from H.R. 5270 goes a long way toward "leveling the playing field" in the international reinsurance marketplace by raising the reinsurance excise tax to four percent (4%) for transactions involving tax haven countries. Moreover, by retaining the one percent (1%) excise tax rate for companies operating in "substantial tax" countries which do not have a U.S. treaty waiver of the tax, the excise tax provision from H.R. 5270 represents a fair compromise of competing concerns. We also applaud the sponsors' inclusion of the anti-conduit requirement which provides that, in order to avoid the increase in the tax to four percent (4%), a "substantial tax" company may not serve as a way-station for reinsurance premiums which are ultimately forwarded to "non-substantial" tax jurisdictions.

I.

The International Reinsurance Industry

Reinsurance is the insurance of risks originally assumed by primary insurers. By allowing primary insurers to minimize their risk exposure, reinsurance serves the important function of enhancing the solvency of primary insurers.

Today, the reinsurance market is truly an international market. There are well over 100 professional reinsurance companies licensed to transact reinsurance business in the United States. In addition, a large number of the primary insurers also assume reinsurance. Many of the domestic reinsurers are themselves owned by foreign persons. In addition, some foreign reinsurance companies operate in the United States through branches. Non-resident reinsurers, on the other hand, do not actually operate in the United States and therefore are not subject to state regulation or U.S. income taxation. Major international reinsurers are located in the United Kingdom, Bermuda, Germany, Switzerland, Sweden, Italy, and Japan, as well as the United States.

Because reinsurance can be placed using little more than a telephone and a facsimile machine, there are no effective impediments, legal or regulatory, preventing non-resident reinsurers from reinsuring risks originally assumed by insurers resident in the United States. In fact, according to data compiled from the National Association of Insurance Commissioners' Annual Statement database, in 1990 non-resident reinsurers accounted for over 40 percent of the domestic reinsurance market.

The 1991 Annual Statement analysis, performed by the Insurance Services Office (ISO) on behalf of the RAA, revealed that unaffiliated non-resident reinsurers received ceded premium of $8.2 billion, a sizeable increase over the $5.15 billion ceded offshore in 1990. The data further revealed that the principal markets for premiums ceded to unaffiliated non-resident reinsurers were:

	PREMIUMS RECEIVED 1990	1991
Bermuda	$1.027billion	$2.510billion
United Kingdom	$1.945b	$2.395b
Barbados	$250million	$802million
Germany	$318m	$495m
France	$121m	$362m
Japan	$124m	$299m

In 1991, non-resident reinsurers affiliated with U.S. insurers, which included over 230 companies in 31 countries from the NAIC database, received reinsurance premiums of $3.1 billion from their U.S. affiliates. The principal countries for reinsurance ceded to non-resident parents, subsidiaries and affiliates of U.S. companies were:

	PREMIUMS RECEIVED[2] 1990	1991
Bermuda	$1.003billion	$1.983billion
Switzerland	$134million	$150million
Sweden	$126m	$ 80m
Barbados	$113m	$126m
Germany	$ 76m	$126m

The RAA recognizes that foreign reinsurers play an important role in providing capital to support the U.S. risk reinsurance market. Nevertheless, as the NAIC Annual Statement database analysis shows, a vast majority of premiums ceded from resident companies to both unaffiliated and affiliated non-resident reinsurers goes to countries such as Bermuda, Barbados and the Cayman Islands, which boast large international financial communities due primarily to the lack of a corporate taxation scheme and a relaxed regulatory environment. It is within this world marketplace that resident U.S. reinsurers currently compete, with the burdens of comprehensive regulation, loss reserve discounting under the 1986 Tax Act, and an otherwise "substantial" domestic corporate tax burden.

II.
U.S. Taxation of Reinsurance

A. Taxation of Resident Reinsurance Companies

Domestic reinsurance companies and foreign reinsurance companies resident in the United States are generally subject to U.S. income tax on their net taxable income. As noted above, a significant provision affecting the income tax burden of resident reinsurers is the 1986 Act rule requiring insurance companies to discount their loss reserve deductions.

Price Waterhouse, the internationally respected independent accounting firm, in its 1989 survey of the effect of the 1986 Act, concludes that the loss reserve discounting rule caused the U.S. income tax burden of the domestic property/casualty insurance industry to increase in the first year after the 1986 Act by almost $1 billion, with the greatest impact on the domestic reinsurance industry. Standard and Poor's reports that resident U.S. reinsurers had a 1991 effective tax rate of 29.5% and have paid federal income taxes which "far exceed initial estimates made by the GAO when TRA 1986 became law."

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[2] None of the Caribbean countries which appear among the ten most active foreign reinsurance markets is known to have a "substantial" effective tax rate on insurance or reinsurance. In the case of Bermuda and the Cayman Islands, the only costs imposed on non-resident exempted insurers (i.e., those insurers conducting only non-domestic business) are the annual corporate licensing fees. Coopers & Lybrand, International Insurance Industry Guide, 4th ed., Lloyd's of London Press Ltd. (1988).

Moreover, a model prepared by members of the RAA indicates that the loss reserve discounting rule would require resident reinsurers, based on conservative assumptions, to increase their premiums at least seven percent (7%) to offset additional tax liabilities resulting from the rule, or suffer possibly a sixteen percent (16%) decline in profitability. This belief is shared by Tillinghast, reputed as the world's leading insurance actuarial firm, which stated that the tax impact of the 1986 Act will "force (domestic reinsurers') prices up a minimum of 4% to 10% just to stay even. Clearly, those non-U.S. jurisdictions without these tax costs will enjoy a very real competitive advantage."[3]

B. U.S. Taxation Of Non-Resident Reinsurance Transactions

Although non-resident reinsurance companies generally are not subject to the U.S. income tax on a net basis, the United States imposes an excise tax of one percent (1%) of the gross reinsurance premiums from U.S. property and casualty risks paid to non-resident reinsurers. Premiums for primary property and casualty insurance paid to non-resident insurers are subject to a four percent (4%) excise tax.

The federal excise tax on insurance and reinsurance premiums paid to non-resident reinsurers has a long history. The purpose of these federal excise taxes is to ensure that insurance transactions originating in the United States, but not subject to U.S. income tax, nevertheless are subject to some level of U.S. tax to maintain competitive equality between resident and non-resident reinsurers. Until the 1986 Act, this treatment, which is conceptually similar to the Internal Revenue Code treatment of other types of income earned by foreign persons, operated tolerably well in providing rough tax parity between resident and non-resident reinsurers.

In contrast to the 1986 Act effect on resident reinsurance companies, however, the 1986 Act failed to adopt any provision that would have a corresponding effect on non-resident reinsurers. By failing to coordinate the 1986 Act income tax changes with the federal reinsurance excise tax, Congress has created an unintended tax subsidy for non-resident reinsurance transactions.[4] In its 1989 report to Representative Fortney (Pete) Stark, the U.S. General Accounting Office stated that ascribing a cause-and-effect relationship between the 1986 Act provisions and the change in the reinsurance market (i.e., the increasing non-resident share of the domestic reinsurance market) "may be premature". It is by now clear that, as the RAA predicted, the tax subsidy in favor of non-resident reinsurance is a substantial factor in the increasing migration of reinsurance premium overseas.[5]

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[3] "TRA '86: the trial period," ReActions (June 1989), at 28. See also Flynn & Walsh, "S&P Study Shows Improved Re Growth, Results", National Underwriter (July 1, 1991) at S14 (tax reform has hurt domestic reinsurers who would lose business if they attempted to raise prices to offset the increase).

[4] See Burcke and Souter, "New Cat Facilities", Business Insurance (September 20, 1993) at 42: Referring to an annual meeting at the 37th Rendez-Vous de Septembre, including officials from a "growing number of property catastrophe reinsurers in Bermuda":

> "The new cat[astrophe] reinsurers chose to domicile in Bermuda **primarily for tax and regulatory reasons**, the executives say, adding that Bermuda also offers the infrastructure needed to operate."

[5] Another contributing factor may be the advantages to the non-resident reinsurer of avoiding state regulation.

This migration is real. According to recent U.S. Department of Commerce statistics, the foreign share of the domestic reinsurance market[6] was approximately $10.5 billion in 1992 (up from $9.9 billion in 1991, $9.2 billion in 1990, and $8.8 billion in 1989). For purposes of comparison, in 1982 the foreign share was $2.5 billion. In particular, Bermuda, which does not impose tax on any insurance transactions, has enjoyed a surge in its volume of U.S. risk reinsurance transactions, from $960 million in 1982 to approximately $2.7 billion in 1992.

This accelerating migration of premiums overseas simply demonstrates the natural consequences of an increased tax burden borne by resident reinsurers only. To restore a roughly equal competitive footing, the property/casualty reinsurance excise tax must be increased, at the very least by raising the tax from one to four percent on reinsurance transactions with companies resident in tax haven countries.

C. Treaty Aspects of the Reinsurance Excise Tax

Against the strong objection of the RAA, a waiver of the reinsurance excise tax remains a provision of the U.S. Model Income Tax Treaty (the "Model Treaty"). In testimony before the House Subcommittee on Select revenue Measures on February 21, 1990, the RAA explained the fundamental opposition of the domestic reinsurance industry to the inclusion of the waiver of the excise tax in the Model Treaty. To summarize the testimony here, the RAA is convinced that the inclusion of the excise tax waiver in the Model Treaty has led to its inevitable inclusion in a number of actual treaties where waiver of the tax was highly inappropriate because the treaty partner did not impose a substantial level of tax on U.S. risk reinsurance transactions.

For example, in considering ratification of the U.S.- Bermuda tax treaty, the Senate Foreign Relations Committee stated as follows:

> The Committee believes that as a matter of public policy, tax treaties should not place any U.S. industry at a competitive disadvantage with foreign competitors, particularly in U.S. markets. The Committee does not believe that those provisions of the U.S. tax laws imposing an excise tax on insurance and reinsurance premiums paid to foreign insurance companies should be waived without prior consultations with the Committees of Congress by Treasury in future tax treaty negotiations.

In the case of the Bermuda treaty (as with the treaty with Barbados, which also contained an excise tax waiver), the treaty partner did not impose a substantial amount of tax (in fact none) on U.S. risk reinsurance transactions entered into by residents of the treaty partner. Consequently, the waiver of the excise tax defeated the very purpose of the tax - to ensure tax equilibrium between reinsurers resident and not resident in the United States. In a letter dated September 22, 1986, by Chairman Rostenkowski of the House Ways and Means Committee to Senator Lugar urging rejection of the proposed Bermuda treaty, Chairman Rostenkowski commented that:

> In the long run, I do not know why any reinsurance activity will take place in the United States, given the mobility of that activity and thus its extreme sensitivity to tax factors.

Although the Senate ultimately ratified the treaty with Bermuda, the excise tax waiver was required to sunset as of December 31, 1989 (as was the waiver contained in the Barbados treaty). The Bermuda treaty exemplifies both the House and the Senate's consternation over the Treasury Department's granting of excise tax waivers by treaty where the effect of the waiver is to eviscerate the objective of fair competition among resident and non-resident reinsurers.

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[6] These figures include both property/casualty and life reinsurance. The RAA believes that most of these amounts relate to property/casualty reinsurance.

In addition to inappropriately-granted treaty waivers, the fair competition objective of the excise tax also can be compromised when reinsurance premium is routed through a country to which the United States has granted a treaty waiver of the excise tax, but which premium is retroceded to another country which has not been granted an excise tax waiver by the United States. Some of these transactions constitute flagrant tax avoidance, such as where premiums ultimately destined for the non-treaty waiver country are "fronted" through the country enjoying a treaty waiver of the tax. Although the Treasury Department generally seeks to prevent this type of abuse by the inclusion of an "anti-conduit" rule in treaties waiving the excise tax, not all treaties contain an explicit anti-conduit rule. For example, the Treasury Department has failed to obtain explicit anti-conduit rules in the U.S. treaties with the United Kingdom, the former U.S.S.R., Hungary, Romania and Malta, although current treaty policy requires the inclusion of an anti-conduit rule any time a treaty waives the excise tax.

The anti-conduit rule is not only an important weapon to combat flagrant tax avoidance, but it also serves the broader purpose of achieving the competitive parity objective of the excise tax. When reinsurance premium is retroceded, directly or indirectly, to a non-treaty waiver jurisdiction without the collection of the excise tax, the real economic benefit of avoiding the tax ultimately will be reflected in the premiums charged. Over time, of course, this will upset the competitive equilibrium in favor of reinsurers which are not eligible to receive excise tax-free premiums yet nevertheless do so.[7]

III.

Legislative Development of the Reinsurance Excise Tax and H.R. 5270

With roots going back to the mid-19th century, the excise tax on insurance premiums in its modern form generally dates back to the Revenue Act of 1918. Under the 1918 Act, a three percent (3%) stamp tax was imposed on policies issued by non-resident foreign insurers and a one percent (1%) stamp tax was levied against policies issued by domestic insurers and resident foreign insurers. In 1921, the one percent (1%) stamp tax was repealed, leaving in place only the stamp tax applicable to non-resident foreign insurers. The legislative history of the 1921 Act, together with subsequent judicial decisions, demonstrate that the Congressional intent in enacting these provisions was to rectify the competitive imbalance resulting because premiums paid to foreign insurance companies not engaged in a trade or business in the U.S. are not subject to any U.S. income tax.

Until the 1986 Tax Reform Act, the one percent (1%) excise tax on reinsurance premiums and the various treaty provisions waiving the application of the tax to certain countries was not a concern to U.S. reinsurers. This was principally because the then-effective U.S. tax burden on domestic reinsurers was negligible.

Even before the 1986 Act, both the Senate, in 1984, and the House, in 1985, considered significant changes to the collection of the property and casualty reinsurance excise tax. These modifications included increasing the rate to four percent (4%), adopting a withholding scheme for the collection of the tax, and eliminating the "cascading" feature of the tax, thereby relieving reinsurance premiums from the excise tax to the extent the excise tax had already been paid on the direct insurance with those risks with a foreign insurer. Both of these measures were deferred in favor of a study by the Treasury Department on whether U.S. reinsurance corporations operate at a significant competitive disadvantage when compared with foreign reinsurance corporations.

The Treasury Department report was finally released in March, 1990, and was entitled "Report to Congress on the Effect of U.S. Reinsurance Corporations of the Waiver by Treaty of the Excise Tax on Certain Reinsurance Premiums" (the "Treasury Report"). Although the RAA has reservations concerning certain of the assumptions and conclusions contained in the Treasury Report, the RAA, nonetheless, is in full agreement with three principal conclusions and observations drawn from the report:

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[7] Cf. Viehe-Naess, "Critique of Insurance Excise Tax Anti-Conduit Rule", Tax Notes (Dec. 24, 1990) at 1473 (suggesting that the anti-conduit rule only should apply to collect excise tax from premiums paid to non-treaty waiver jurisdiction reinsurers in the most egregious abuse situations). This suggestion simply fails to address the primary underlying intent of both the excise tax and waivers of the tax, which is to ensure competitive parity.

(1) Non-resident reinsurers located in countries which do not impose a material level of tax on U.S. risk reinsurance premiums have a significant competitive advantage over U.S. reinsurance companies if the excise tax imposed on such premiums is waived by treaty;

(2) If the reinsurance excise tax were increased to four percent (4%) but not waived by treaty, non-resident reinsurers which are not subject to material home country taxes, and in certain circumstances other non-resident reinsurers, still may enjoy a competitive advantage over U.S. reinsurance companies; and

(3) All treaties which contain a waiver of the reinsurance excise tax should also contain an anti-conduit rule.

The conclusions contained in the Treasury Report represent solid support for the sponsors' proposal from the provision in H.R. 5270 to raise the excise tax from one percent (1%) to four percent (4%) for reinsurance premiums ceded to jurisdictions which do not impose a "substantial" level of tax.[8] The excise tax provision from H.R. 5270 represents a legitimate step toward rectifying the competitive imbalance represented by reinsurance premium ceded to "low-tax" countries as documented in the Treasury Report.

In addition to the evidence supporting an increase in the excise tax for reinsurance premiums which go to low-tax countries, the Treasury Report advocates the inclusion of an anti-conduit rule, the need for which is referred to as "self-evident."

> . . . without such a limitation, a company established in a treaty jurisdiction that benefits from the waiver could receive an exempt premium from the United States and immediately reinsure the risk with a company in a non-exempt country **(including a tax haven)**. . . . The third country resident would enjoy the full benefit of the exemption from the U.S. excise tax, while the U.S. would sacrifice its tax revenue without receiving commensurate benefits.

In keeping with U.S. treaty policy that anti-conduit provisions are necessary to assure that benefits from the reinsurance excise tax waiver are realized only by those intended to so benefit, the RAA commends the sponsors the current proposal for including an anti-conduit rule as one of the requirements which must be satisfied in order to qualify for the reduced one percent (1%) excise tax rate and for providing that procedures be adopted to ensure that the excise tax is in fact collected when due.

In July 1992, the RAA submitted a statement to the Ways and Means Committee in connection with hearings held on H.R. 5270. That statement advocated reform of the property/casualty reinsurance excise tax regime to enhance competitiveness. On behalf of a large segment of the domestic professional reinsurance industry, the RAA applauds the efforts reflected in this provision from H.R. 5270 to address an important issue related to international competitiveness, and the emphasis of the new administration on tax fairness in international tax policy; and, before legislation is enacted, to obtain a full record on competing interests in this sensitive area. Nevertheless, the RAA is convinced that over the years a more than ample record has been established to support an increase in the reinsurance excise tax in the manner set forth in the provision from H.R. 5270, and that further delay in enacting a similar form of relief for the domestic reinsurance industry is not only unwarranted but highly damaging.

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[8] In fairness, we would suggest that the determination of a "substantial tax" should reflect the reinsurer's national, regional and local income tax burden.

IV.
Conclusion

The reinsurance excise tax provision under consideration, incorporated by reference from H.R. 5270, limits the modest increase in the excise tax to those non-resident reinsurers who are not subject to a substantial home country tax. Although this provision does not reach as far as the original RAA position, the RAA recognizes that this narrowly targeted increase in the excise tax rate will address the principal inequities represented by companies operating in countries which are subject to a negligible tax rate, if any at all.

A further advantage of the targeted approach contained in the provision from H.R. 5270 is its respect for existing U.S. treaty relationships with many foreign trading partners. The RAA does not favor legislation which would override existing tax treaties.

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32nd Annual RIMS Conference
New Orleans LA
April 17-22 1994

September 22, 1993

BY OVERNIGHT MAIL
The Honorable Charles B. Rangel
Chairman, Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Re: Hearing on Miscellaneous Revenue-Raising Proposals -
Tuesday, September 21, 1993
"A Proposal from H.R.5270 to Increase, from 1% to 4%, the
Excise Tax on Reinsurance Premiums Paid to Foreign Persons"

Dear Chairman Rangel:

The Risk and Insurance Management Society, Inc. (RIMS) would like to offer comments regarding the above-referenced proposal. We request that these comments be included in the Committee's record in connection with the recent hearings on the Miscellaneous Revenue-Raising Proposals.

RIMS is a not-for-profit association of more than 4,500 corporate, governmental, charitable and institutional consumers of commercial insurance products and services, located in 90 chapters throughout the United States and Canada. RIMS' membership, which includes 85 percent of the Fortune 1,000 companies, runs the gamut from The Walt Disney Company to the School District of Philadelphia to the Red Cross to Tulane University. The RIMS membership represents, on a premium volume basis, the largest group of insurance consumers in the world. A significant portion of that premium volume is reinsured with foreign reinsurers. Therefore, the proposal to raise the excise tax on reinsurance ceded abroad from one to four percent is of great concern to RIMS members, since it is these policyholders that will ultimately pay the cost of any additional tax.

RIMS believes that increasing the excise tax on reinsurance ceded abroad from one to four percent is anti-consumer, protectionist and

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unnecessary. We strongly urge you and the committee to reject this proposal.

Any increase in the federal excise tax would be a double-edged sword held to the throat of U.S. insurance consumers - one side being affordability, the other availability. Congress has in the past been deeply concerned with keeping insurance available and affordable for U.S. insurance consumers. Very few public policy concerns have been more consistent or more widely supported. Raising the federal excise tax would seriously undermine this clear congressional policy.

The burden of an excise tax increase would be largely passed through to insurance consumers through higher premiums. After witnessing the price escalations suffered in the mid-1980's, RIMS members and policyholders in general are skeptical of any actions which would arbitrarily inflate the cost of insurance.

Foreign reinsurers play an important role in the volatile domestic insurance market by assuming risks often considered undesirable by U.S. insurers and reinsurers. Foreign reinsurers tend to compliment domestic reinsurance capacity by reinsuring certain lines of business, such as product liability, environmental hazard and medical malpractice coverage, which the U.S. market often is not prepared or willing to accept. By reinsuring these risks, foreign reinsurers increase the capacity of domestic primary insurance carriers and allow those domestic companies to provide more and broader types of insurance coverage.

An increase in the excise tax will only discourage access to this important reinsurance capacity. The cost of doing business in this market will become prohibitively expensive and U.S. policyholders and domestic primary insurers will be forced to utilize the only market left accessible - the domestic reinsurance market. Limiting access to the foreign reinsurance market will leave U.S. policyholders at the mercy of domestic reinsurers, a market that would be free from competitive concerns. In this scenario, RIMS members can only look forward to paying higher premiums and getting less coverage.

It is no coincidence that the domestic reinsurers are supporting this proposed excise tax increase. They argue that this increase is needed to put U.S. reinsurers on a level playing field with foreign reinsurers. RIMS questions the validity of this argument and quite frankly, believes it to be shallow and unworthy of serious consideration. Domestic reinsurers are asking for this excise tax increase merely to provide a cover for hiking their premiums. They are asking you to impede access to foreign reinsurance for many coverages which they choose not to offer or only to offer at a higher cost.

Through this proposed excise tax increase, the domestic reinsurers are, in effect, asking Congress to do away with their competition. RIMS is asking you and the other committee members to preserve a highly competitive insurance market that provides easy access to affordable coverage for U.S. policyholders. The only way to preserve this market is to reject the proposed excise tax increase.

Another potential problem RIMS sees growing out of this proposed excise tax increase is that RIMS members, many of which are multinational companies, could potentially feel the retaliatory wrath of other nations if this hike in the reinsurance excise tax is perceived by foreign nations as an attempt at protectionism.

The United States continues to promote talks on the liberalization of trade in the service industries as a part of the General Agreement on Trade and Tariff (GATT) negotiations. An increase in the reinsurance excise tax is wholly inconsistent with that goal and would counter U.S. efforts in this area if the tax is perceived by U.S. trading partners as a barrier to entry into U.S. markets. A real fear for RIMS members is the imminent threat that other nations may reciprocate by erecting barriers that prevent U.S. companies from gaining access to foreign markets. This would have a devastating impact on U.S. businesses and the U.S. economy.

Perhaps most alarming, the excise tax proposal would override waivers of the federal excise tax found in various existing treaties. These existing tax treaties benefit both treaty partners and the benefits of these treaties to U.S. insurance consumers should not be taken lightly. Many U.S. companies with foreign operations have taken these treaties into account when designing those foreign operations. Any unilateral change in the treaty system would upset this balance and would undoubtedly produce negative consequences for U.S. businesses.

In an even broader sense, tax treaties are part of the United States' comprehensive approach to global relations. The unilateral abrogation of an excise tax waiver would go far beyond the bounds of domestic tax, revenue and insurance policy - it would materially change our country's foreign policy.

In this regard, RIMS understands that the federal excise tax has been bound at one percent in the North American Free Trade Agreement (NAFTA). Should Congress approve this proposal to increase the federal excise tax on reinsurance ceded abroad, it would be a violation of NAFTA. In addition, increasing the federal excise tax at this time would have negative consequences on our negotiators' efforts to achieve additional access to foreign markets.

Finally, proponents of an excise tax increase anticipating substantial revenue gains for the U.S. Treasury will likely be disappointed. Insurance premiums, which are deductible business expenses, would inevitably increase as a result of this proposal. The increased deduction taken by the policyholder/taxpayer would lessen any potential revenue gain that Treasury hopes to realize.

To summarize, RIMS opposes any increase of the federal excise tax on reinsurance ceded abroad, as such action is blatantly anti-consumer, protectionist and contrary to the foreign policy interests of the United States in today's global economy. In addition, RIMS does not see any substantial offsetting benefit to the United States which would outweigh the severe negative impact of this proposal. RIMS therefore urges the Subcommittee on Select Revenue Measures and the entire Ways and Means Committee to summarily reject this proposal to raise the excise tax on reinsurance ceded abroad from one to four percent.

Sincerely,

Paul S. Brown
Director of Government & Public Affairs
and General Counsel

cc: Members of the Subcommittee on Select Revenue Measures

TESTIMONY OF MR. DAVID BELDING, CHAIRMAN, NEVADA RESORT ASSOCIATION, IN OPPOSITION TO A PROPOSED INCREASE IN THE EXCISE TAX ON WAGERS

WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES
CONGRESSMAN CHARLES RANGEL, CHAIRMAN
SEPTEMBER 21, 1993

I wish to take this opportunity to record my opposition to a proposal suggested to this Committee recommending that the federal excise tax on wagers be increased from one-quarter percent to one percent.

Originally, the excise tax on wagers was enacted as part of the Revenue Act of 1951. In imposing an excise tax on wagers, both the Ways and Means Committee and the Senate Finance Committee clearly stated in their Reports on this legislation that their aim was to collect taxes from gambling activities that were "comparatively free [of taxation] from either State or Federal Governments." In other words, these excise taxes were not aimed at gaming operations that were regulated and taxed by State governments, but at activities which were operating outside State laws. The proposal now before this Subcommittee stands this principal on its head by calling for an increase in excise taxes on legal wagering activities, already regulated and taxed by State government. There is no sound tax policy behind this proposal.

The impact of this proposal, intended or not, falls almost exclusively on gaming companies located in Nevada. And, this impact would be devastating. Sports books in Las Vegas average between 1-percent and 2.5-percent gross margins on wagers. Gross margins represent the amount wagered less payouts. Gross margins have declined in recent years as bettors have become more sophisticated, using computers and other technological aids to improve their odds. Legal sports books operate today on an extremely fine margin. As a result, after-tax profit margins on wagers average only about .5-percent to .75-percent. In reviewing and analyzing the wagering activities of several major casinos in Las Vegas for the last five years, we find that in almost every instance the proposed wagering excise tax increase results in after-tax losses by the sports books. Clearly, sports books cannot absorb this additional tax and remain profitable. The result is that many Hotel/Casinos would cease sports book operations. We do not believe that it is the intent of this Subcommittee, or Congress as a whole, to tax legal gaming operations out of business.

Additionally, forcing Hotel/Casinos to cease wagering operations would reduce the amount of revenues that the federal and State governments now receive from sports book activities. The effect of ceasing sports book operations at one medium sized Las Vegas casino, alone, has been estimated to cost the federal government $2 million in revenues over the next five years. The loss to the State of Nevada would be almost $1 million.

On the other hand, sports books cannot pass the additional tax through to their customers. Bettors would simply shift their business to illegal wagering operations. Tilting the playing field in favor of illegal and unregulated wagering, and against legitimate, regulated wagering activities would move in exactly the opposite direction from what Congress intended when it first established wagering excise taxes four decades ago.

These findings give renewed meaning to the statement, "The power to tax is the power to destroy." Proposals such as the one suggested to this Subcommittee to increase wagering excise taxes point out the danger in proposing changes in the tax treatment of business activities without a thorough knowledge of how the business operates.

The Hotel/Casinos which make up the backbone of Nevada's economy will make a major contribution to efforts to reduce the nation's federal budget deficit through changes in the tax laws enacted as part of the 1993 Budget Reconciliation Act. Because of these new tax laws, they will not only pay higher corporate taxes, but the tourist industry, their economic mainstay, will suffer because of higher fuel taxes and the reduced value of tax deductions for business travel, meals and entertainment expenses. This will, in turn, reduce available funds to State and local governments that depend on revenues from gaming operations. The gaming industry and the people of Nevada accepted these changes because of the dire need to gain control of our federal deficit for the good of all Americans, and because the burden will be shared by all sectors of our economy.

However, with the ink hardly dry on the Reconciliation Act, some members of Congress are proposing another round of tax increases. This time the new taxes are not to go for some overwhelming national need. Instead, tax increases are proposed for some segments of the economy in order to pay for tax breaks for other more favored taxpayers. The motive here is not sound tax policy. Nor is there justification that such changes are needed for the greater good of the country. No, this is strictly a case of robbing Peter to pay Paul, of pitting one segment of the economy against another in order to provide favored treatment to a selected group of taxpayers. These attempted parochial raids on the gaming industry cannot be justified. We will fight these proposals with all our strength.

These proposed tax increases on the gaming industry are neither fair, nor do they reflect sound tax policy. We urge the Subcommittee to reject them.

STATEMENT OF DECKER ANSTROM, ACTING PRESIDENT, NATIONAL CABLE TELEVISION ASSOCIATION TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES, COMMITTEE ON WAYS AND MEANS, UNITED STATES HOUSE OF REPRESENTATIVES REGARDING PROPOSED EXCISE TAX ON CABLE TELEVISION SERVICES

SEPTEMBER 23, 1993

Mr. Chairman, Members of the Subcommittee, the National Cable Television Association, which represents cable companies serving more than 80 percent of all cable subscribers in the United States and more than 60 cable programming networks engaged in creating and distributing a broad range of programming, appreciates the opportunity to offer the cable television industry's views regarding the proposed extension of a three percent excise tax to cable television services.

The cable television industry strongly opposes the imposition of an excise tax on cable television services, and believes that such a tax is wholly inappropriate for a number of reasons.

First, there is no policy rationale for levying an excise tax on cable television services. Cable is not an essential service and an excise tax would, in effect, penalize the 58 million households in the United States who turn to cable television for news, information and entertainment. Indeed, the imposition of a three percent excise tax would directly raise cable television subscribers' monthly bills. The average cable television subscriber now pays about $33 per month; this excise tax would raise that monthly bill by about $1.00.

Second, it is certain that as the imposition of an excise tax on cable services raises subscribers' bills, some subscribers will react to their increased bills by electing to discontinue cable service. As a consequence, an excise tax on cable service will cause cable television operators' revenues to be reduced. This reduction in operators' revenues would be occurring at precisely the same time that cable companies are already struggling with a more than $1 billion decrease in revenues resulting from the Federal Communication Commission's rules implementing the reregulation of the cable television industry. This reduction in industry revenues has already jeopardized the ability of the cable television industry to pay its existing debt and puts at risk the significant investments the cable industry plans to make in equipment, infrastructure and programming needed to bring "Information Age" services to consumers. Any further reductions in revenue due to the imposition of an excise tax will only add to these difficulties.

Finally, the cable television industry already pays substantial specifically targeted taxes in the form of franchise fees and user fees. Cable systems pay approximately five percent of their total revenues to the local communities they serve as a franchise fee. These fees will total approximately $1.1 billion in 1993, or about $1.60 per cable subscriber per month. Additionally, in the budget reconciliation bill passed in August, Congress imposed a new "regulatory" fee on the cable television industry in the form of a user fee. This fee, which cable systems are required to pay, is a burden that will cost the cable television industry approximately $20 million per year.

The cumulative effect of increased regulatory fees, decreased revenues due to reregulation, and now a possible decrease in revenues due to the imposition of an excise tax would be unfair.

Most fundamentally, the imposition of this excise tax would ultimately force consumers to pay more for cable service or cause them to disconnect service altogether, an outcome that is totally at odds with the interests of the nearly 60 million people who subscribe to, and enjoy, cable television.

Mr. Chairman, Members of the Subcommittee, for the above-stated reasons we respectfully ask that you reject the proposal to impose an excise tax on cable television services.

STATEMENT OF THE
NEWSPAPER ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
SEPTEMBER 21, 1993

The Newspaper Association of America (NAA) appreciates the opportunity to comment on a proposal to repeal Section 4253 (b) of the Internal Revenue Code -- the exemption for news services from the communications excise tax.

The Newspaper Association of America is a non-profit trade association representing approximately 1,250 newspaper in the United States and Canada. NAA members account for more than 80 percent of the U.S. daily and Sunday newspaper circulation. Many non-daily newspapers also are members of NAA.

A 3-percent Federal excise tax is imposed on amounts paid for local and toll (long distance) telephone service and teletypewriter exchange services. According to the Joint Committee on Taxation, exemptions from the communications excise tax are provided for a number of organizations and institutions such as: the American Red Cross, servicemen in combat zones, nonprofit hospitals, educational organizations, state and local governments and news services that utilize telephone toll services for gathering and disseminating the news (news organizations are not exempt from the excise tax on local telephone service). [1]

The exemption from the communications excise tax for news services was adopted as a means of fostering a free and vibrant press, and continues to serve that purpose. For example, during the Persian Gulf War, the telephone served as the principal pipeline for the dissemination of news and information from the Middle East. While satellite communications and direct modem links between remote laptops to newsrooms desks were used by some news organizations, most news organizations relied heavily on teletypewriter (wire) services and telephone facsimile machines to transmit news reports from the Gulf region. Fax transmissions were especially important in transmitting news reports from organized military press pools. This use of the telephone to transmit information enabled newspapers to provide background and extensive analysis to explain the complex issues surrounding the Gulf War - at a very low cost to newspaper readers.

As many newspapers and other news organizations are well aware, covering the war in the Persian Gulf proved to be a costly proposition. Expanded news coverage by newspapers led to additional operating costs for salaries, paper and ink. These costs were incurred at a time when newspapers and other media were experiencing a sharp decline in advertising revenue brought on by the recession. The exemption from the communications excise tax eased the financial burden on newspapers and helped underwrite some of the cost of providing expanded war coverage to newspaper readers.

The Newspaper Association of America believes the exemption for news services from the communications excise tax assists newspapers and other media in providing the public with a broad range of information every day at a low cost. Furthermore, the current tax is imposed only on users of the public switched network. Users of private networks, satellite, or microwave communication systems are already exempt from the tax. Consequently, repeal of the exemption will fall primarily on smaller newspapers and other media operations which are more dependent on the public network than the larger companies which may have private networks or satellite operations.

While the NAA recognizes that the Congress has a challenging task to meet the revenue needs of this country, we believe the public will not be well served by increasing the costs of news gathering by newspapers, broadcast stations, news magazines and news wire services. We therefore, strongly urge the Committee to reject this proposal.

We respectfully ask that this statement be included in the hearing record.

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[1] Joint Committee on Taxation Staff Description of Miscellaneous Revenue Proposals Scheduled for Hearings September 8, 21 and 23 before the House Ways and Means Select Revenue Measures Subcommittee," Issued September 17, 1993.

Statement of:

Eric Vaughn
President and Chief Executive Officer
Renewable Fuels Association

Before the

Committee on Ways and Means
Subcommittee on Select Revenue Measures

Regarding:

Ethanol and Carbon Dioxide Production

Washington, D.C.

September 23, 1993

On behalf of the members of the Renewable Fuels Association, the national trade association for the domestic ethanol industry, I would like to express my appreciation to the Chairman, and the Members of the Subcommittee, for this opportunity to submit testimony in response to comments presented to the Subcommittee on the effects of the ethanol tax incentive on the carbon dioxide industry in the United States.

The United States Congress is on record in support of encouraging the increased production and use of domestically-produced renewable energy and renewable, alternative industrial products. The domestic ethanol industry is therefore very concerned by several inaccurate and misleading statements made by Mr. J. Vernon Hinely, Chairman of of Carbonic Industries Corporation, regarding the production and marketing of carbon dioxide (CO2) by domestic ethanol producers.

It is important for Members of the Subcommittee on Select Revenues to understand the facts surrounding the production and marketing of liquid carbon dioxide from ethanol production facilities.

First: The production of ethanol from agricultural commodities, such as corn, through the process of fermentation, results in the production of raw carbon dioxide as a co-product. The entire domestic ethanol industry produces less than 10 percent of all the carbon dioxide produced and marketed in the United States. The total, estimated CO2 market in the United States today is approximately 20,000 tons per day. The total domestic ethanol production of carbon dioxide is estimated at 2,000 tons per day. To suggest, as Mr. Hinely does, that the domestic ethanol industry will "soon have a monopoly on CO2" is absurd.

Second: The ethanol tax incentives that Mr. Hinely refers to are not available to the producers of ethanol. The ethanol tax incentive is available only to companies that manufacture and market gasoline. Not a single ethanol producer in the United States is legally allowed to apply for even one cent of the ethanol marketing incentive.

Third: Companies such as Carbonic Industries Corporation, purchase carbon dioxide from a variety of sources such as natural gas companies, crude oil refiners and ethanol producers. Carbon dioxide is a byproduct in the production and processing of natural gas (anhydrous amonia), crude oil-hydrocarbon cracking (hydrogen) and fermentation of renewable agricultural feedstocks (ethyl alcohol). Every company in the world that produces "food grade" liquid carbon dioxide, uses similar production and purification processes, the same chemicals, virtually identical amounts of electrical power and similar numbers of workers. Mr. Hinely states that "(T)he cost of converting raw carbon dioxide to a food grade liquid by an ethanol producer can be minimal". The cost components required to process raw carbon dioxide and purify it into food grade, liquid carbon dioxide is virtually identical to every other CO2 processor in the country.

The ethanol industry's average cost for the production of liquid carbon dioxide is approximately $15 per ton. The other 90 percent of the liquid carbon dioxide is produced at costs that range from very efficient facilities for an estimated $12 per ton to less efficient facilities for an estimated $18 per ton.

Fourth: The cost directly associated with the transportation from production facility to end user can be as much as 50 percent of the cost of carbon dioxide to a purchaser in the beverage industry, food processors, water treatment facilities, welding companies, aspirin manufacturers and makers of baking soda. Because ethanol facilities are located in the upper Midwestern part of the U.S. they are actually at a competitive disadvantage in the carbon dioxide market due to the fact that their transportation costs are significantly higher when compared to many carbon dioxide producers located at or near markets for carbon dioxide on the West Coast, upper East Coast and the Gulf Coast states.

Fifth: Giant international corporations, such as, the British Oxygen Corporation (a United Kingdom corporation) Hoescht Industries (a German manufacturing conglomerate) and L'Air Liqude (a French industrial corpoation) are the world's leading processors and marketers of liquid carbon dioxide. These companies, not domestic ethanol producers, dominate and largely control the marketing and production of carbon dioxide in the United States. These companies are also leading producers and marketers of other industrial gases which provides them with tremendous marketing and distribution advantages across the entire industrial gas market in the United States and around the world.

Finally: The comment that ethanol producers are engaged in "one of the most vigorous and widespread cost cutting campaigns in the history of the U.S. CO2 industry in an attempt to also control the market for finished liquid carbon dioxide" as Mr. Hinely states in his testimony before the Subcommittee, is not supported by the facts. Far from attempting to "control" the CO2 market with the result being "higher prices to all consumers of CO2 without the checks and balances of unobstructed free trade", as Mr. Hinely states in his testimony, it is the major carbon dioxide manufacturers themselves that are involved with law suits, Grand Jury investigations and consent decrees all to address serious allegations of anti-competitive business practices and possible price fixing.

ETHANOL TAX INCENTIVE PROGRAM

In 1990, the Congress voted overwhelmingly to extend the existing federal tax incentive program through the end of the decade, to allow the fledgling domestic ethanol industry to mature, and to promote the economic, environmental, and energy security policy objectives.

Prior to Congressional consideration of the Omnibus Budget Reconciliation bill in 1990, which included provisions of H.R. 3906, the Energy and Environmental Security Act of 1990 to extend ethanol tax incentives, the U.S. General Accounting Office (GAO) released a report on the agricultural and budgetary impacts of the ethanol tax incentive program. The GAO Report verified conclusions reached by several previous industry and government studies which stated that the federal alcohol fuel tax incentive program actually saves the government monies in reduced farm program costs and increased rural income.

The GAO concluded that with more ethanol produced, the demand for and price of corn would increase, causing fewer farmers to participate in farm support programs, fewer farmers to default on their commodity loans, and decrease deficiency payments and acreage diversion program payments. The report showed reductions in federal outlays from farm support programs that would average about $900 million and $1.4 billion per year, respectively, under a low-growth and high-growth scenario. According to GAO, "the cumulative outlay reductions over the 8-year period would total about $7.4 billion and $11.4 billion, respectively."

Importantly, both GAO's growth simulations assumed significant reductions in target prices over the eight year period. GAO ran a separate simulation of its high-growth model, however, using target prices fixed at their 1990 level. That scenario showed farm program reductions averaging about $3.5 billion per year with cumulative reductions totalling more than $28 billion!

Acknowledging that continuation of the excise tax exemption for ethanol-blended fuels was necessary to stimulate the growth and development in the industry necessary to meet the increased ethanol production assumed in both the low-growth and high-growth scenarios, GAO also calculated projected losses to the government resulting from reduced gasoline excise tax revenues. Based on a simple calculation of projected gallons less the exemption, GAO estimated that the low-growth and high-growth simulations would further reduce tax revenue by an annual average of $440 million and $813 million, respectively.

GAO concluded, however, that the average net impact to the federal government resulting from the federal ethanol program would be a savings of between $460 million and $610 million. Over the eight year period, the government would save between $3.7 billion and $4.7 billion.

In addition to a net savings to the government, the GAO Report concluded that the increased demand for corn used in the production of ethanol would increase farm income substantially. Under the high-growth scenario, more than 1.3 billion bushels of corn wold be processed into 3.3 billion gallons of ethanol, 8 million tons of protein-rich corn gluten feed for poultry, and more than 1.9 million tons of gluten meal used to feed dairy cows. As a result of this added-value for corn, the average corn prices over the low and high growth simulation periods increased about 12 cents and 22 cents per bushel, respectively.

In short, the ethanol tax incentives create jobs, open new markets for feed grains that are by-products of the ethanol production process, reduce dangerous emissions of carbon monoxide and ozone, decrease our dependence on imported oil, and save money for the federal government.

Conclusion:

In a letter to Congressman Dick Durbin in January discussing his support for expanded market opportunities for ethanol, then President-elect Clinton observed:

> Our nation's policy toward ethanol has suffered from a lack of decisiveness in past years. The "on-again, off-again" nature of this policy has limited our ability to create an infrastructure capable of integrating ethanol into the array of fuels available. A policy should be established that looks to the long-term, thereby providing certainty to our farmers, refiners and distributors.

President Clinton's observation is absolutely on target in describing the challenge which has faced the domestic ethanol industry in the past, and his words are instructive to this Subcommittee as it considers measures to increase the use of renewables. This is a critical time in the development of the domestic ethanol industry, and we would be pleased to work with the Members of the Subcommittee to assure the increased production and use of renewable energy.

Thank you.

TESTIMONY OF MARK CHERRY
MACK TRUCKS, INC.

Mr. Chairman and Members of the Subcommittee, I want to thank you for the opportunity to present this statement on behalf of Mack Trucks, Inc. commenting on a proposal which would increase the heavy truck chassis excise tax from 12 percent to 12.1 percent.

My name is Mark Cherry and I am Director of Taxes of Mack Trucks, Inc. Mack is one of North America's largest producers of heavy-duty diesel trucks, in addition to major product components; the company also markets a line of medium-duty diesel trucks throughout North America. Mack vehicles are sold and serviced in more than 65 countries worldwide. Mack has about 4,700 domestic employees working primarily in Pennsylvania, Maryland and South Carolina.

Mack is unalterably opposed to raising the retail excise tax on heavy trucks and tractors. Given the country's current fiscal situation, I understand the need to narrow the budget deficit. However, as the attached exhibit shows (Attachment 1), the highway transportation industry is already taxed at a significantly higher level than its air, rail and inland waterway competitors. It is difficult to understand why Congress would consider another increase in the truck excise tax (the rate was increased from 10% to 12% in 1983) when the retail excise tax on airliners, tugboats, barges, locomotives and railroad rolling stock is 0%.

I think that it is imperative that you consider the relative competitive aspects of any proposed tax changes.

I am not suggesting that Congress impose an excise tax on the air, rail and inland waterway transportation industries. Rather, I suggest that you reduce taxes on the highway transportation industry until the playing field is level. Competition is difficult enough without having to incur such a wide array of taxes. After the taxes imposed on the competing transportation modes are equalized (start by eliminating the unneeded complexities in administering the truck excise tax), the proper revenues can be generated by taxing all players on an equal and consistent basis.

By decreasing excise taxes, Congress would effectively provide new momentum for the trucking industry. At the very least, Congress should prevent the Internal Revenue Service ("IRS") from applying the excise tax in a discriminatory fashion. While the statutory rate is 12%, the IRS, through its regulatory authority, has determined that two separate rates exist, depending upon the identity of the seller and on the article sold. The IRS has held that sales of heavy trucks and tractors by a subsidiary dealer of a manufacturer, producer or importer from a permanent retail establishment are taxed at 12%, while the same trucks and tractors sold through the retail establishment of the manufacturer, producer or importer are taxed at 12.48%, reflecting a presumed markup of 4%. The same penalty rate applies to direct sales by the manufacturer, producer or importer which, because of their complexities, are seldom transacted through dealerships. There is no basis for such discriminatory treatment and, at a minimum, affected manufacturers should be able to demonstrate to the IRS that their sales were made on an arm's-length basis. The rationale for equal treatment for all such sales is set forth in the attached paper captioned "Federal Retail Excise Tax" (Attachment 2).

Indeed, in debating the Conference Report to H.R. 11, the Revenue Act of 1992, Senator Arlen Specter engaged in a colloquy with then-Finance Committee Chairman and now Secretary of the Treasury Lloyd Bentsen, clarifying the treatment of such manufacturer, producer or importer sales. The colloquy, as it appears in the Congressional Record of September 26, 1992, is attached (Attachment 3). Specifically, then-Chairman Bentsen and the Ranking Member of the Finance Committee, Senator Bob Packwood, agreed that (1) an artificial markup should not be applied if it would yield inequitable results, and (2) the manufacturer, producer or importer should be accorded the opportunity to document its sales as being made on an arm's-length basis and hence subject to the normal 12% excise tax. Unfortunately, the IRS has not responded to this Congressional direction and continues to apply the arbitrary markup percentage to such sales.

Therefore, to clarify the appropriate treatment of such sales made by manufacturers, producers and importers, Section 4051 should be amended. (See Attachment 4.)

In conclusion, Mack Trucks, Inc. registers its strong opposition to the proposal to increase the truck excise tax. We urge you to consider lowering the excise tax or, at a minimum, clarifying it in order to prevent the IRS from applying differing rates to manufacturers of the same vehicles which are sold in arm's-length transactions to third parties.

Again, I understand the need to generate revenue and, like most taxpayers, Mack Trucks, Inc. is willing to pay its fair share. Likewise, I hope that you recognize that the trucking industry is operating in a highly competitive environment and that fair competition requires a level playing field.

ATTACHMENT 1

Federal Taxes on Transportation				
	Transportation Mode			
Type of Tax	Highway	Inland Waterway	Rail	Air
Retail Excise (§4051)	12%	-	-	-
Highway Use (§ 4481)	$550/year (A)	-	-	-
Tire Excise (§4071)	$10.50 + .50 ¢/# over 90 #	-	-	-
Motor Fuels (§§ 4042, 4081) (As of 10/1/93)	24.4 ¢/gal.	20.4 ¢/gal. (B)	6.9 ¢/gal. (C)	.1 ¢/gal. (D)
Harbor Maintenance (§4461)	-	.125% (E) (F)	-	-
Commercial Transportation (§4271)	-	-	-	6.25% (F)

A. Applies to vehicles with gross vehicle weights in excess of 75,000 (including trailer)
B. Increases to 24.4 ¢/gal. on 1/1/95
C. Drops to 5.65 ¢/gal. on 10/1/95
D. Increases to 4.4 ¢/gal. on 10/1/95
E. Tax doesn't apply where motor fuels tax is paid
F. Tax is imposed upon the property owner, not the shipper

ATTACHMENT 2

FEDERAL RETAIL EXCISE TAX

General

Section 4051 of the Internal Revenue Code imposes an excise tax upon the retail sale of certain heavy trucks, tractors and trailers. While the statutory tax rate is 12%, the IRS has determined that two separate rates exist depending upon the seller of the article and the article sold. According to the IRS, the situation is as follows

Type of Taxable Article - Seller	Tax Rate
• All Trailers	12%
• Heavy Trucks and Tractors	
-Sold by independent distributor	12%
-Sold by subsidiary dealer (where dealer earns a markup of at least 4%)	12%
-Sold by subsidiary dealer (where markup is less than 4%)	12.48%
-Sold directly by the manufacturer	
Company-owned retail establishment (regardless of markup)	12.48%
Direct Sale	12.48%

Congress was concerned that heavy truck and tractor manufacturers might sell their vehicles at less than full retail price. This could have two effects.

1. Undercut the prices offered by independent distributors.
2. Reduce the amount of tax that would otherwise be paid.

Consequently, Congress established a presumption that heavy trucks and tractors sold by the manufacturer are sold at a price which is less than full retail value. However, the legislative history indicates that this presumption is rebuttable. Unfortunately, the regulations issued by the Treasury Department do not provide the possibility for rebuttal and simply add 4% to the selling price of all such vehicles except in certain circumstances where the manufacturer sells through a related party.

Sales By Company-Owned Retail Establishment

The federal retail excise tax law and underlying regulations have been interpreted by the IRS to mean that a company-owned retail establishment, operating in the same manner and under similar circumstances as a subsidiary dealer, must pay tax at a higher rate than the subsidiary dealer. This is so because only the subsidiary dealer can avail itself of the "Permanent Retail Establishment Exception" (PREE). The PREE

1. applies where the taxable vehicle is "sold through a permanent retail establishment in the normal course of the trade or business of being a retailer", and
2. provides for a tax rate of 12% rather than the 12.48% rate which otherwise applies to sales made by a manufacturer's retail establishment or subsidiary dealer.

There is no logical reason why a distributorship owned directly by the manufacturer should be taxed differently than a distributorship owned by a manufacturer's subsidiary.

Solution: Provide clarification, effective for sales made on or after October 1, 1987, that a company-owned retail establishment is entitled to the PREE where it meets the same conditions applicable to a subsidiary dealer.

"Section 4052(b)(4)(B)(iii) Retail Establishment. For purposes of clause (ii), a retail establishment owned directly by a manufacturer, producer, or importer shall be considered to be a person."

Direct Sales

The Direct Sales business typically involves a retail customer interested in acquiring a large volume of similarly-optioned models for delivery at numerous locations throughout the country. Such sales emphasize complex negotiations, large volume transaction processing, and diverse and capital-intensive financing services. An independent distributor does not have the financial resources, personnel or transactions processing capabilities necessary to handle all aspects of the Direct Sales business. Moreover, a large volume customer would prefer not to have to deal simultaneously with many individual dealerships located throughout the country. Since

1. sales of heavy trucks and tractors sold in these circumstances are normally made directly by the manufacturer,
2. trailer sales made under similar circumstances and made directly by the manufacturer are taxed at a rate of 12% rather than 12.48%, and
3. Congress provided for the possibility that heavy trucks and tractors sold directly by the manufacturer can be sold at a full retail selling price,

there is no reason that arm's-length retail sales of heavy trucks and tractors made directly by the manufacturer should not be subject to tax at 12% rather than 12.48%.

Solution

Provide clarification, effective for sales made on or after October 1, 1987, that sales made by the manufacturer, importer or producer at an arm's-length selling price are subject to tax at a rate of 12%. "Section 4052(b)(4)(C) Presumed markup percentage in certain cases. The presumed markup percentage referred to in subparagraph (A)(ii) shall be 0 when

(i) the manufacturer, producer, or importer of any article (or a related person) is liable for the tax imposed by this subchapter with respect to such article,
(ii) the purchaser of the article is not in the business of reselling such articles, and
(iii) the article is sold in an arm's-length transaction."

Revised Code Section 4052(b)(4)

(4) Special rule where tax paid by manufacturer, producer, or importer.

(A) In general. In any case where the manufacturer, producer, or importer of any article (or a related person) is liable for tax imposed by this subchapter with respect to such article, the tax under this subchapter shall be computed on a price equal to the sum of--

(i) the price which would (but for this paragraph) be determined under this subchapter, plus
(ii) the product of the price referred to in clause (i) and the presumed markup percentage determined under paragraph (3)(B).

(B) Related person. for purposes of this paragraph--

(i) In general. Except as provided in clause (ii), the term "related person" means any person who is a member of the same controlled group (within the meaning of section 5061(e)(3)) as the manufacturer, producer, or importer.
(ii) Exception for retail establishment. To the extent provided in regulations prescribed by the Secretary, a person shall not be treated as a related person with respect to the sale of any article if such article is sold through a permanent retail establishment in the normal course of the trade or business of being a retailer.
(iii) Retail establishment. For purposes of clause (ii), a retail establishment owned directly by a manufacturer, producer, or importer shall be considered to be a person.

(C) Presumed markup percentage in certain cases. The presumed markup percentage referred to in subparagraph (A)(ii) shall be 0 when

(i) the manufacturer, producer, or importer of any article (or a related person) is liable for the tax imposed by this subchapter with respect to such article,
(ii) the purchaser of the article is not in the business of reselling such articles, and
(iii) the article is sold in an arm's-length transaction.

ATTACHMENT 3

workers out of work. That is the situation we face today.

Mr. President, quite simply put, LRC has informed me that it will likely be forced to close if liability is imposed for the outstanding tax, especially since LRC's business competitors are not liable for those same taxes. This has subsequently led to an overwhelming call by the community for a legislative solution to the impending job losses.

Earlier today, I introduced legislation to effect this change. My question to the chairman of the Finance Committee is whether you would work with me to address this problem and achieve some acceptable solution that is fair to the workers.

Mr BENTSEN. I would be pleased to work with my friend and committee colleague to find a way to address this problem. While as chairman of the Finance Committee I cannot commit to any particular changes at this time, I certainly understand my friend's concerns about the workers and their families in his State and his desire to save their jobs. I will do what I can to be helpful.

Mr. DIXON. Mr. President, current law requires that ESOP's be "designed to invest primarily" in the stock of the employer. Although there are no regulations on point, this has been interpreted by some to mean that at least 50 percent of the plan's assets must be stock in the employer.

The recently passed unemployment compensation amendments of 1992 significantly expand the ability of employee participants in qualified deferred compensation plans to roll over distributions from such plans, including partial distributions, to individual retirement accounts, or IRA's, without incurring any tax liability. This change will undoubtedly encourage employees to increase rollovers from all types of qualified plans, including employee stock ownership plans, or ESOP's.

What concerns me is that this expansion of rollover rights may unintentionally jeopardize the status of certain ESOP's. If employees, using these new rights, choose to withdraw employer stock from their ESOP accounts and roll the stock into IRA's, the overall percentage of employer stock held by the plan could fall, at least temporarily. While such voluntary withdrawals by employees, which are beyond the control of the employer, don't change the purpose for which the employer designed the plan, concerns have been raised that the resulting decline in the percentage of plan assets invested in employer stock might cause the plan no longer to be deemed to be designed to invest primarily in the employer's stock.

Ironically, this would cause the greatest problems for plans that afford their employees the greatest flexibility. Where, for instance, a plan permits employee contributions to be invested other than in the stock of the employer, and the employees have wide latitude to make partial withdrawals, there is the greatest risk that withdrawals will put the plan at risk, at least for a period of time. Moreover, under the code's anticutback provisions, employers who generously designed their plan to give employees these options cannot now withdraw them in order to protect their plan and other plan participants.

Any such disqualification would be disastrous, particularly for the participating employees and their beneficiaries. Employees would incur taxable income on contributions made by the employer to the plan even though they would not receive a current distribution, and they would lose any ability to roll over plan assets without incurring additional tax. The plan could lose its tax exemption, and, if so, the trustee, employer, and lender to the plan would all then be exposed to a variety of tax liabilities and other penalties. For all these reasons, it is critical that we clarify that employee rollovers from ESOP's to IRA's under the recent amendments were not intended to affect whether the plan is designed to invest primarily in the stock of the employer under section 4975(e)(7) of the Internal Revenue Code merely because such rollovers cause the plan's investment in employer securities to temporarily fall below 50 percent of plan assets.

Mr. President, while the expanded rollover opportunities that passed in the unemployment bill earlier this year could potentially jeopardize some ESOP plans, I do not believe these new rollover opportunities were intended to create difficulties for ESOP plans that give their participants considerable investment flexibility. I would like to ask the distinguished chairman of the Finance Committee whether he agrees with me that the intent of Congress was clearly not to jeopardize ESOP's that give their participants flexibility, and that the impact of the changes made in the unemployment bill on employee elections should not, for purposes of section 4975(e)(7), affect the determination of whether a plan is designed to invest primarily in qualifying employer securities merely because the plan's investments in employer securities fall temporarily.

Mr. BENTSEN. Mr. President, the distinguished Senator from Illinois is correct. The unemployment bill that passed earlier this year was never intended to jeopardize ESOP's that give their participants substantial flexibility.

Mr. DIXON. I thank the distinguished chairman for his understanding and for his assistance.

LEASED EMPLOYEES

Mr. KERRY. Mr. President, I have two questions regarding a clarification of the "leased employee" provision in the bill.

Mr. BENTSEN. I would be pleased to offer any clarifications.

Mr. KERRY. First, when we considered a similar provision on June 23, 1989, you concurred with my understanding that under the definition of "leased employee" then proposed, the fact that an individual's services are not preformed under the control of the intermediary party that arranged for the individual to perform the services for the recipient company does not, by itself, necessarily lead to the conclusions that the individual's services are performed under the control of the recipient company. The services may instead be performed under the control of the individual himself or under the control of an entity other than the intermediary third party or the recipient company. This issue was then, and still remains, particularly important in my State of Massachusetts where a substantial number of workers provide services through brokers as independent contractors. Would my understanding on this point still be correct today under the present bill?

Mr. BENTSEN. It would be.

Mr. KERRY. Second, the explanation of the bill states that the service recipient must exercise control over a worker for the worker to be considered a leased employee. The explanation also states that the determination is made on all the facts and circumstances. I am concerned that this definition not be extended beyond the original intent of the "leased employee" provisions to reach certain professionals like attorneys; accountants and actuaries; doctors; and computer programmers, systems analysts, software and hardware engineers; and other similarly skilled professionals who typically are under the general control of the service recipient. Often the service recipient's establishment of the techniques and methods to be used, and its requirements that work be performed on-site and according to certain stages and timetables, is dictated in many respects by the very nature of the work itself; also there is general direction given as to the results to be obtained. However, this type of general control by service recipients does not appear to be significant in the overall context of the day-to-day work of these professionals who regularly make substantial use of their own judgment and discretion on matters of importance in the performance of their services. Accordingly, this type of general control would not be of whether these professionals are "leased employees." Is my understanding correct of how the "control" test would apply to these workers?

Mr. BENTSEN. Yes, it is correct.

TRUCK EXCISE TAX

Mr. SPECTER. Mr. President, I would like to engage the distinguished managers of the bill, the chairman and ranking member of the Senate Finance Committee, in a brief colloquy concerning the excise tax on trucks which is dealt with in the miscellaneous provisions title of this bill. Although the provision being considered in this bill deals with an exemption for certain educational institutions, my inquiry deals with a more general Internal Revenue Service interpretation of the statute as it enforces a 1987 amendment which clarified the treatment of direct sales made by manufacturers, producers, and importers.

Specifically, in 1987 the Congress clarified that the 12-percent excise tax on trucks being sold at retail by manufacturers, producers, and importers should be assessed against their selling price plus a presumed markup percentage as determined by the Secretary of the Treasury. Apparently, the provision was intended to ensure that direct sellers would pay a tax comparable to that paid by independent third party distributors. However, the conference report supporting this amendment noted that:

> The conferees do not intend that the Treasury Department apply the new presumptive retail sales price rule to such transactions if the lessor/seller establishes that the price to the ultimate user of the vehicle represents an arm's length retail sales price.

Mr. President, the conferees apparently anticipated circumstances that do not lend themselves to a mechanical application of a presumed markup percentage. But Treasury, in its regulations, has imposed an inflexible application of a 4-percent markup without granting the taxpayer the ability to rebut that presumption by providing information to show that its sales have been made at arm's length.

In practical terms, the purchaser of a truck does not make a distinction as to whether a seller is a manufacturer, a company-owned retail outlet, or an independent distributor; price is the determinative factor and in many cases the sales price to a purchaser may be the same no matter who the seller. Yet the manufacturer which sells directly or through its retail outlet is disadvantaged because it must tack on an additional 4-percent presumed markup percentage, for purpose of the tax, and either increase the price to the customer and possibly lose the sale or absorb the add-on. But such sales have been made on an arm's-length basis which is exactly what the Congress wished to recognise as the basis for the excise tax. Thus, the presumed markup computation need not be followed where its application is not necessary to carry out the purposed of the provision and, indeed, creates a distortion in its application.

Mr. President, I would like to say to the distinguished managers of the bill that I, of course, do not wish to rewrite this provision of the Tax Code in my dialog with them. But I would like to ask the distinguished chairman of the Finance Committee if he agrees that, before imposing an arbitrary 4-percent markup percentage on the selling price to establish a basis for the excise tax on trucks sold by manufacturers, producers, and importers, the Internal Revenue Service should accord the taxpayer an opportunity to rebut that presumption, consistent with the intention of Congress, by showing that such sale or sales were made on an arm's-length basis and hence provide the appropriate basis for tax.

Mr. BENTSEN. I agree with the statement of the distinguished Senator from Pennsylvania. In establishing the presumed-markup-percentage concept the Congress granted the Secretary a tool to establish a basis for tax which would generally equate to the price of a sale made in an arm's-length transaction. However, the Congress specifically said that it did not intend that this rule be applied if the taxpayer establishes that the price to the ultimate user represents an arm's-length retail sales price. Therefore, if application of the presumed markup percentage would yield inequitable results, the taxpayer should be provided the opportunity to document its sales as being made on an arm's-length basis and have that arm's length sales price, unadjusted for any presumed markup, be the appropriate basis for assessment of the tax.

Mr. SPECTER. I would also direct the same inquiry to the distinguished ranking member.

Mr. PACKWOOD. I agree with the response of the distinguished chairman.

RETROACTIVE CHANGES IN THE TAX LAW

Mr. SYMMS. Mr. President, I would like to engage the distinguished chairman of the Finance committee in a colloquy regarding retroactive changes in the tax law and the IRS imposing penalties subsequent to those changes in the tax law.

Mr. BENTSEN. I would be happy to discuss this matter with the Senator from Idaho.

Mr. SYMMS. As the chairman of the Finance Committee is aware, Congress occasionally makes retroactive changes in the tax law. When this occurs taxpayers affected by this change in law must resubmit their tax return and pay additional tax liability. I am concerned that the IRS may attempt to impose penalties retroactively on these taxpayers. I do not believe it is the intent of Congress to impose these penalties on taxpayers for changes in the tax law that did not exist when these taxpayers originally submitted the tax return. I hope that the chairman of the committee could clarify congressional intent regarding penalties and retroactive changes in the tax law.

Mr. BENTSEN. It is not the intent of Congress for the IRS to impose penalties on taxpayers who must pay additional taxes due to retroactive changes in the tax law. The IRS uses penalties to discourage taxpayers from avoiding their tax liability or paying it late. If taxpayers come into timely compliance with any retroactive change in the tax law by paying their tax liability, I do not believe the IRS should impose penalties due to the retroactive change in tax law.

Mr. SYMMS. I thank the Senator from Texas for clarifying congressional intent concerning retroactive changes in the tax law as it relates to penalties. I am sure that thousands of taxpayers are relieved that the Congress did not intend that the IRS would impose penalties on changes in the Tax Code that did not exist before Congress retroactively changed them.

RURAL ENTERPRISE ZONES

Mr. GRASSLEY. Mr. President, I am following up on an issue I raised in the Finance Committee mark up on the legislation before us.

In that mark up, I made the point that while I strongly supported including rural enterprise zones in the bill, it was important that the tax benefits in the bill not encourage corporate farming at the expense of family farms.

We want—and we need—rural enterprise zones to be included in this bill. A number of weeks ago, I wrote to the President, as well as to Senator BENTSEN, chairman of the Finance Committee, encouraging them to support rural enterprise zones in the enterprise zone package that was being put together. I am very grateful that rural enterprise zones were included in both the President's and the chairman's proposals.

In our effort to assist urban communities in the aftermath of the Los Angeles riots, we can't forget the needs of our rural communities. It is very unfortunate, but there are rural areas in my State of Iowa that have a similar per capita income as south central Los Angeles. These rural communities need help too, and I am encouraged that this need has been recognised.

However, in our effort to help these communities, we have to be careful that we do not do more harm than good.

Under the committee bill, and even more so in the House version, corporate interests were given potentially dangerous tax incentives to invest in agriculture. These investments would further damage the very existence of the family farm. We have seen the damage done when tax benefits have been given to corporations to invest in agriculture. The resulting unfair competition, overproduction and depressed prices led to the loss of thousands of family farms across the country.

Mr. President, we do not need more corporate investment in farming. We need more corporate investment in rural diversification.

Nonagricultural, diversified business investment will help many of these hard-hit rural communities get back on their feet, without interfering with or competing with the local farming infrastructure.

I am very encouraged that, following the committee markup, the chairman took my concerns and suggestions in mind and did modify the committee bill to limit benefits to farming operations that consist of under $500,000 in total assets over a lifetime. This is certainly strong movement in the right direction. But, at this point, a few con-

ATTACHMENT 4

At the appropriate place, insert the following:

Sec. ___, SPECIAL RULES FOR COMPUTATION OF EXCISE TAX ATTRIBUTABLE TO CERTAIN TRUCK AND TRACTOR SALES.

(a) IN GENERAL. -- Paragraph 4 of Section 4052(b) is amended --

(1) by adding the following clause after clause (ii) of subparagraph (B):

"(iii) Retail establishment. For purposes of clause (ii), a retail establishment owned directly by a manufacturer, producer or importer shall be considered to be a person" and

(2) by adding the following subparagraph after Subparagraph (B):

"(C) Presumed markup percentage in certain cases. The presumed markup percentage referred to in subparagraph (A)(ii) shall be 0 when:

(i) the manufacturer, producer or importer of any article (or a related person) is liable for the tax imposed by this subchapter with respect to such article,

(ii) the purchaser of the article is not in the business of reselling such articles, and

(iii) the article is sold in an arm's-length transaction."

(b) Effective Date. -- The amendments made by this section shall apply to sales made on or after October 1, 1987.

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Mt Holly North Carolina

September 20, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

Dear Ms. Mays:

The National Truck Equipment Association (NTEA) strongly opposes the House Ways and Means Select Revenue Measures Subcommittee's proposal to increase the excise tax on heavy truck chassis from 12 to 12.1 percent.

The NTEA represents over 1,500 companies, most of them small businesses, throughout the nation that manufacture and distribute work related trucks, truck bodies and equipment. Many of these vehicles are subject to the heavy truck chassis excise tax. The burden of determining and collecting this tax falls on NTEA members.

While a 0.1 percent increase may seem small, it is important to remember that the payers of this tax are businesses that just endured a large increase in either corporate or individual tax rates and a very large increase in the tax on motor fuels. These companies are already shouldering more than their fair share of the nation's tax burden. Further, given that both buyers and sellers of these vehicles are just now beginning to emerge from a recession, Congress should be encouraging expenditures on new capital goods and not discouraging such purchases through increased taxation.

Another issue of concern is the complexity of administering this particular excise tax. Commercial

30th Annual NTEA Convention
SUPERSHOW VII
The Commercial Truck & Equipment Exposition
March 16-19, 1994 • Dallas, Texas

trucks are generally built to a customer's specifications and completed with the equipment that customer needs to perform the job for which the vehicle is built. Applying the excise tax is not so simple as just saying every vehicle chassis over a certain size is taxable. The vehicle may or may not be taxable depending on how it was built and what equipment is added. This determination must often be made by looking at past IRS letter rulings and guessing how they might be applied by the IRS to the vehicle you are building, given that field agents often tend to be less than knowledgeable with regard to this particular tax. In fact the IRS often calls the NTEA for information on the application of this excise tax.

As a result of the complexity of this excise tax, many conservative businessmen find themselves at a 12 percent disadvantage when bidding on a vehicle sale to other businesses which may take a more aggressive interpretation of the IRS regulations. Increasing the excise tax simply makes it harder for conservative and honest businessmen to compete. If you want to change the heavy truck excise tax make the tax simpler to apply so that no gray areas exist and then let the IRS field offices spend their time on other tax collections.

The NTEA would welcome the opportunity to work with the Ways and Means Committee and other interested industry groups to reform this excise tax.

Sincerely,

Mike Kastner

Michael E. Kastner
Director of Government Relations
NTEA Washington, D.C. Office

[AN ATTACHMENT TO THIS LETTER IS BEING RETAINED IN THE COMMITTEE FILES.]

Truck Trailer Manufacturers Association

1020 PRINCESS STREET
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RICHARD P. BOWLING
PRESIDENT

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Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

The following statement is submitted on behalf of the Truck Trailer Manufacturers Association specifically relating to the proposal to increase the federal excise tax on heavy trucks and trailers from 12.0% to 12.1% which is under consideration by the Select Revenue Measures Subcommittee.

TTMA is the sole national organization serving the manufacturers of heavy duty truck trailers. Our member companies build all types of commercial trailers and our associate members are the suppliers of components and material for trailer manufacturing. TTMA trailer manufacturing companies account for approximately 90% of U.S. trailer production.

Any changes in federal excise tax on heavy trucks and trailers should be the subject of separate hearings so that all interested and affected parties might have the opportunity to present their views.

We concur with the U.S. Department of the Treasury statement for the record that we are also unaware of any justification for an increase in heavy truck and trailer excise tax at this time.

We would be pleased to furnish any additional information which the subcommittee might desire.

Sincerely,

Richard P. Bowling
President

RPB/mm

TESTIMONY OF AMERICAN FOREST AND PAPER ASSOCIATION

The American Forest and Paper Association (AFPA) is pleased to present written testimony before the Select Revenue Subcommittee of the House Ways and Means Committee in opposition to proposals to tax the use of the important fumigant methyl bromide. AFPA believes that a tax on man-made methyl bromide, before EPA assembles scientific data to determine whether methyl bromide is or is not an ozone depleting compound, is not justified and would cause economic hardship to the forest and paper industry.

The American Forest and Paper Association (AFPA) is the national trade association of the forest, pulp, paper, paperboard, and wood products industry. AFPA represents approximately 550 member companies and related trade associations (whose members are in the thousands) which grow, harvest, and process wood and wood fiber, manufacture, pulp, paper and paperboard products from both virgin and recovered fiber and produce solid wood products. As a single national trade association, AFPA represents a vital national industry which accounts for over 7% of total United States manufacturing output and 90 percent of domestic recycled paper manufacturing capacity.

Employing some 1.4 million people, this industry ranks among the top 10 manufactuers in 46 states, with an annual payroll of about $46 billion. The forest and paper products industry generates sales of $200 billion annually, and as a significant exporter to global markets, makes an important contribution to the U.S. balance of payments. A tax imposed on the use of man-made methyl bromide would inhibit this industry's ability to regenerate the forests after harvest, make it more difficult and costly to control insects and disease, and have a negative effect on our ability to export wood products.

AFPA believes that a tax on methyl bromide is unwarranted at this time because: (1) EPA has not determined if methyl bromide is or is not an ozone depleting compound, (2) the scientific data base is inadequate to determine methyl bromide's role in depleting the ozone layer, (3) the economic impact to the U.S. forest products industry and other agricultural industries is very substantial, and (4) a tax on methyl bromide would not reduce overall use because of the lack of viable substitutes.

(1) CONGRESS SHOULD AWAIT AN EPA FINAL DETERMINATION REGARDING THE OZONE DEPLETION POTENTIAL OF METHYL BROMIDE

On March 18, 1993, EPA proposed to classify methyl bromide as a Class I ozone-depleting substance and to terminate its production and use in the year 2000 (58 Fed. Reg., 15014.) EPA acknowledged that there are significant uncertainties about the role of methyl bromide in depleting the ozone layer, that methyl bromide is critical to the agricultural industry (including forestry), and that no adequate alternatives exist. Several other federal agencies including the U.S. Department of Agriculture (USDA) and the Department of Energy (DOE) have opposed EPA's proposal. As a result, it is unlikely that EPA will issue a final rule within the foreseeable future.

Until EPA takes final agency action to add methyl bromide to the list of Class I ozone-depleting substances, it is premature for the House Select Revenue Subcommittee to place a tax on methyl bromide based on its alleged role in ozone depletion.

(2) THE SCIENTIFIC DATA BASE IS CURRENTLY INADEQUATE TO IDENTIFY METHYL BROMIDE AS AN OZONE DEPLETING SUBSTANCE

The June 1992 United Nation's Environment Program (UNEP) Scientific Assessment Update for methyl bromide stated unequivocally that "The current state of scientific knowledge concerning bromide compounds in the atmosphere is considerably less developed than the corresponding understanding of chlorine compounds." The document was peer reviewed by many of the world's leading atmospheric scientists who unanimously agreed that there are many uncertainties associated with the science related to the ozone depletion potential (ODP) for methyl bromide.

At the November, 1992, Copenhagen Meeting of the Parties to the Montreal Protocol, the Parties took the recommendations by the Science Panel into consideration and concluded that given the paucity of data to support an ODP and the importance of the compound to agriculture worldwide, no level of phase-out can be justified as this time. Instead, the Parties agreed to qualify their recommendation for an ODP as a "best estimate" and conduct an in-depth study over the next two years.

Another report released by the U.S. Department of Energy (DOE) entitled "Overview of the DOE Atmospheric Chemistry Program's Ozone Project" concluded that the agency was unable to predict with confidence the ozone-depletion potential of methyl bromide, among others. DOE recognizes that the data are incomplete for decision making and has recommended additional research to clarify the many areas of uncertainty.

In view of the UNEP assessment report, the recent DOE report, and the actions taken by the Parties to the Protocol in Copenhagen, AFPA believes that the data do not support classifying methyl bromide as an ozone depleting substance at this time. It follows that the Select Revenue Subcommittee also lacks sufficient evidence to support a tax on methyl bromide, based on concerns about ozone depletion.

(3) THE ECONOMIC IMPACT OF DISCOURAGING METHYL BROMIDE USE ON THE FOREST PRODUCTS INDUSTRY WOULD BE SUBSTANTIAL

In AFPA's comments to EPA on its March 18th proposal, the economic impact of a complete ban on the use of methyl bromide to our industry alone would be almost $7 billion in present value over the next 50 years, or an annual equivalent of over $424 million. This is an indication of the importance of methyl bromide to our industry and demonstrates the need for EPA and Congress to exercise extreme caution in prematurely discouraging or terminating the use of methyl bromide.

In the forest and paper industry, the three primary uses of methyl bromide include: (1) fumigation of seedling nursery beds for insect, disease and weed control; (2) fumigation of leaf cutting ant colonies; and (3) fumigation of logs prior to export. Based on our review of our surveys, we found that a substantial amount of log fumigation occurs at foreign ports of entry and, therefore, would not be affected by a tax in this country. The effect of a tax in the U.S. would simply drive the use of methyl bromide abroad to other countries.

In our comments to EPA, we also pointed out that the economic effects extend beyond the direct loss in seedling values and higher seedling cost to long term timber supply. It would also result in inadequate seedlings for other reforestation efforts such as erosion control, wetlands restoration, and wildlife enhancement.

All of the above uses of methyl bromide are vital to the forest products industry, from initial reforestation and stand establishment to eventual sale of the product in international markets. Government policies that discourage the use of methyl bromide would have significant repercussions throughout the industry.

(4) A TAX ON METHYL BROMIDE WOULD NOT DISCOURAGE USE BECAUSE OF THE LACK OF SUBSTITUTES

Imposing a burdensome tax on true ozone depleting substances would have the predictable and planned effect of encouraging users to seek less environmentally damaging alternatives. While this rationale may make sense for some substances, it would not hold true for methyl bromide because of the lack of adequate substitutes. Methyl bromide is the only single pesticide that has a wide range of biological efficacy, economic efficiency, and relatively benign environmental effects.

Given the lack of substitutes for methyl bromide, the forest products industry would be forced to pay the tax and any well-intentioned reduction in overall use would not be realized. Even if the use of methyl bromide were to be discouraged by the proposed tax, forest tree nurseries would be forced to resort to multiple applications of a variety of chemicals, some of which have their own environmental risks and down-sides. And as noted previously, fumigation of imports/exports would simply be shifted overseas.

USDA also noted in their comments to EPA that "the likelihood of developing new, effective fumigant alternatives to methyl bromide appears very remote." Even if new fumigants were to be developed, there is a considerable burden associated with registration of such alternatives under FIFRA. Obtaining a registration requires the generation of a great amount of data and analysis, which can take several years and cost millions of dollars. And at the end of the process, there is no guarantee EPA would register the new use. Again, users of methyl bromide would likely pay the tax and overall use would not decline as theorized.

CONCLUSION

As AFPA has documented in our comments to EPA and in the above testimony, there is no doubt about the importance of methyl bromide to agriculture and forestry. There are also no doubts that there are no safe and approved substitutes to methyl bromide. And, it is reasonably certain that if methyl bromide use is discouraged by a tax, reforestation and international trade in forest products would be likewise discouraged. However, there are serious doubts about the assertion that man-made methyl bromide harms the earth's protective ozone layer. Given current information and understanding, a burdensome tax on methyl bromide is not justified.

Congress should instead ensure that sufficient research is conducted over the short term to allow the federal agencies with expertise to reach consensus on the ozone depletion potential of methyl bromide. The Select Revenue Subcommittee would best serve the interests of the economy and the environment by not taking action to tax methyl bromide until EPA, in consultation with the other agencies, has rendered a final decision.

Thank you again for the opportunity to alert you to the uncertainties associated with the link between methyl bromide and ozone depletion. AFPA is prepared to provide any additional information on the forest and paper industry's use of methyl bromide that the Subcommittee might desire.

[THE ATTACHMENT TO THIS STATEMENT IS BEING RETAINED IN THE COMMITTEE FILES.]

[BY PERMISSION OF THE CHAIRMAN]

ASOCIACION DE
EXPORTADORES DE CHILE A.G.

Santiago de Chile, October 1st 1993

Rep. Charles B. Rangel
Chairman
Select Revenue Measures Subcommittee
1105 Longworth House Office Building
Washington, DC 20515
USA

Dear Sir:

The Chilean Exporters' Association is a private non-profit organization of fruit and vegetable exporters whose members account for about 90% of total Chilean produce exports.

We have been informed about EPA's intention to ban methyl bromide as an ozone depleter in a near future, a decision which would seriously harm both our country and industry. For your information we are sending you herewith a copy of this Association's comments to EPA Director/Administrator Mr. William K. Reilly last year.

According to the latest scientific findings on this subject, more comprehensive research would be needed before EPA could make a final decision having such a dramatic impact.

We kindly ask you to read the attached copy and to take into consideration the strong economic and scientific arguments against banning methyl bromide under present circumstances, principally the lack of safe and effective alternatives.

Sincerely yours

CHILEAN EXPORTER'S ASSOCIATION

Rónald S. Bown F.
President

Attachments
RB/akh

Cruz del Sur 133 • Piso 2 • Las Condes • Teléfono (02) 2066604 • Fax (02) 2064163 • Casilla 10096 Centro • Santiago • Chile

ASOCIACION DE
EXPORTADORES DE CHILE A.G.

Santiago de Chile, March 31st, 1992

The Honorable Mr. William K. Reilly
Director/Administrator
U.S. Environmental Protection Agency (E.P.A.)
401 M. Street Southwest
Washington, DC 20460
U.S.A.

Dear Sir:

The purpose of this letter is to express our deep concern over the proposed EPA action to classify the fumigant Methyl Bromide as a potential ozone depleter. We are also deeply concerned with the EPA intention of introducing an amendment to the Working Group of the Montreal Protocol in an attempt to influence that group to support the proposed EPA classification effort. While we refer to our own concern we recognize ourselves to be part of a larger community with whom we share similar doubts over the proposed actions of your Agency.

Since we became aware of this matter we have had extensive contact with our various representatives as well as with many growers, receivers and distributors from the United States. From our review of the matter we have all concluded that in view of (1) the limited stratospheric science surrounding the fumigant Methyl Bromide and (2) the extremely significant economic consequence of its loss, any action taken by the EPA at this time would be patently premature.

On behalf of the Chilean Exporters' Association, a private institution whose members are exporters of fresh fruit and vegetables, accounting for about 90% of total Chilean export volume, I should like to make the following specific comments on the above issue:

Cruz del Sur 133 • Piso 2 • Las Condes • Teléfono (02) 2066604 • Fax (02) 2064163 • Casilla 10096 Centro • Santiago • Chile

ASOCIACION DE
EXPORTADORES DE CHILE A.G.

1. During the 1990/1991 produce export season (extending from September 1st, 1990 through August 30th, 1991) Chile exported about 130 million boxes of fresh fruit and vegetables to the world, generating a foreign currency income of some US$ 948.5 million. After mining, fishery and forestry, our sub-sector of the economy ranks fourth as hard currency producer, with 10.6% of the country's exports, totalling last year some US$ 8.9 billion. [Updating note: During the 1992/1993 season, some 139 million boxes worth an estimate US$ 900 million were exported. In 1992 total Chilean exports amounted to US$ 10.1 billion and fresh produce accounted for about 9% of that amount.]

   The fresh fruit and vegetable industry employs 150.000 people directly, a figure representing about 18% of labor occupied in agriculture and 4% of total Chilean labor force, amounting to an estimated 4 million people.

2. The main Chilean export fruit species are table grapes. Last season [i.e., 1990/91] 60 million boxes were exported with returns of US$ 496 million, of which 35 million boxes were sent to the US market which represents about 68% of total exports of this species. The economic impact in the United States side of our fruit export business should also be considered - longshoremen, warehouse and warehousemen, trucking, U.S. fumigators, terminals and terminal operators, importers as well as USDA, FDA and U.S. customs jobs.

3. As you surely know, fumigation with Methyl Bromide (MeBr) is an import requirement for table grapes set up by the U.S. Department of Agriculture as a compulsory treatment to control some insects and mites considered as quarantine for American agriculture.

   In addition it is mandatory to apply MeBr to Chilean lemons and it also is an alternative treatment for stonefruit (peaches, apricots, nectarines and plums). Last season, the total volume of those species exported to the U.S. reached about 10.5 million boxes.

To comply with the above mandatory requirements, the Chilean fruit industry has implemented over 100 fumigation facilities throughout the fruit growing regions. These facilities (fumigation chambers) have been built up with all possible modern technology inputs and with due concern to the health of chamber operators and other workers that might be exposed to this chemical.

4. At present, and in accordance with the requirements established by the agency under your direction, MeBr is under the EPA re-registration scheme. Consequently, a MeBr Industry Panel Task Force was established with the purpose of financing and submitting the complete toxicological and residue information requested by your Agency. Together with other important American users, this Association is a member of said panel; this fact shows the outmost importance this chemical has for our country's fruit industry as well as the disastrous impact that a decision to ban or reduce future applications would have on our national economy.

5. We wish to point out that regardless of efforts made by research so far, no other chemicals or procedures have been found which could efficiently replace MeBr as a fumigant. Furthermore, any alternative product or procedure would first have to be approved by the US Department of Agriculture as a means to control quarantine insects and mites. As you know, U.S.D.A.'s approval procedures for any alternative solution imply a long and costly process. This is why in our opinion we deem it necessary to continue using MeBr as a fumigant for Chilean table grapes, lemons and stonefruit destined to the US market.

6. We believe to represent the feeling of our authorities in this matter, as well as of several hundred thousands of Chilean workers, growers, exporters and American traders of our produce. We trust you also agree with us about the fact that some questioning regarding the use of MeBr should be adequately investigated and clarified by analytical means, as it is being done at present with the information requested by your Agency for the re-registration of this fumigant.

ASOCIACION DE
EXPORTADORES DE CHILE A.G.

We also firmly believe that the petition filed by some environmental groups in your country is based upon rather emotional grounds. In our view, that petition is based on a brisk and emotional position therefore lacking sufficient scientific support for a decision of such a far reaching impact. As you may know, most of the MeBr found in the atmosphere occurs naturally, being produced by algae in the oceans.

A matter of special concern for us is that it is precisely the less industrialized and developed countries which eventually would have to bear the hardest consequences of this kind of restrictions. Furthermore, the less developed countries do not have the financial, industrial or technological means to cope with this kind of restriction. This is why any reduction or banning of this chemical would become a real punishment for our economy and its people and, at the same time, would become a limiting barrier to free trade. Also, in our opinion, this action by EPA would greatly interfere with President Bush's program "Enterprise for the Americas".

Finally, Mr. Reilly, we kindly ask you to accept this letter in the spirit as it is written, namely to make you aware of the importance of Methyl Bromide for our country as well as the economic impact of any EPA decision to reduce or ban that chemical's use, particularly if no alternatives are currently available or under study.

We are at your disposal to supply you with any further information you may deem necessary regarding the above.

Sincerely yours,

CHILEAN EXPORTERS' ASSOCIATION

Ronald S. Bown F.
President

TESTIMONY SUBMITTED BY THE ASSOCIATION OF HOME APPLIANCE MANUFACTURERS

SEPTEMBER 23, 1993

The Association of Home Appliance Manufacturers (AHAM) represents manufacturers of home appliances produced and sold in the United States. AHAM is adamantly opposed to an addition of hydrochlorofluorocarbons (HCFCs) to the list of taxable ozone-depleting chemicals in Code section 4682. HCFCs are substitutes for CFCs and will be used in refrigerator insulation and as a refrigerant in other products.

There are several reasons we maintain this opposition. First, HCFCs are transitional compounds and are accepted by EPA and the parties to the Protocol because viable substitutes are not available. Home appliance manufacturers are researching and developing environmentally sound alternatives in anticipation of replacing HCFCs. For example, HCFC-141(b), which is **90%** less ozone depleting than CFCs, will be used as a blowing agent for foam insulation only until 2003 when its production will be phased out in accordance with EPA proposals. Note that these alternative refrigerants must allow proper functioning of a refrigerator for 20 years as well as continued adherence to federal energy standards which no other nation requires. Research on alternatives can not be "half-done." The consequences of such action could result in even greater damage to the atmosphere, consumer harm, and the destruction of one of the last, great U.S. manufacturing industries.

Second, The CFC tax was enacted in 1989 to accelerate appliance manufacturers' phase-out of these compounds. However, much of the decrease in appliance industry use of CFCs was largely caused by chemical company decisions to halt production as well as revisions to the Montreal Protocol (Protocol) and EPA's implementation of the Clean Air Act. As you may know, the Protocol has been amended repeatedly and requires a complete CFC phaseout by January 1, 1996. An HCFC tax would unfairly penalize the American home appliance industry for operating in an environmentally responsible manner and for supporting and complying with an accelerated CFC phase-out schedule. It is important to remember that industy's motivation to accelerate CFC phase-out began prior to enactment of the CFC tax.

Furthermore, it is critical that the use of HCFCs not be penalized because their use enables U.S. refrigerators to meet federal energy standards and helps mitigate global warming. Europeans do not have to meet such standards. Products manufactured and sold in Europe often can not match the high energy efficiency levels of U.S. manufactured products. A punitive tax at this juncture will not be an incentive, but rather a deterrent to full CFC phaseout and development of additional alternatives.

Third, just like many of U.S. businesses, America's appliance industry has been in a recession. Statistics show the appliance industry is beginning to pull out of it and the work force has begun increasing. However, it remains a delicate balance. Simply put, an HCFC tax would cost America's appliance manufacturers millions of dollars. An HCFC tax will have a negative impact on manufacturers' ability to invest in projects that are designed to make our industry globally competitive, including: energy efficiency, research & development, and product design.

Using the same taxation approach on HCFCs, as is used currently on CFCs, would have a serious effect on the home appliance industry. Funding now dedicated to the research and development of alternatives would have to be redirected to payment of the tax. Thus, production and implementation of new alternatives to HCFCs could actually take much longer than is currently anticipated.

Fourth, a tax on HCFCs will have an adverse impact on the American consumer. It would be especially onerous to the poor and lower-middle income consumers who could least afford possible retail price increases. The net effect of this tax will be to add cost without commensurate added value in consumer features.

Fifth, the appliance industry supports the market-driven approach. In today's environmentally conscious society, an environmentally safe product has greater appeal to a consumer. Therefore, an incentive for early phase-out of HCFCs already exists in competition among appliance manufacturers. To deplete the monetary resources needed to develop a safe alternative, in order to pay a tax, just doesn't make sense.

In conclusion, AHAM believes an HCFC tax would constitute bad public policy and would prolong the recession for America's appliance manufacturers. There has to be a better way to raise revenue than by taxing chemicals whose days are numbered. We urge the committee to consider these factors carefully.

UNITED TECHNOLOGIES CARRIER

Carrier Corporation

PO Box 4808
Carrier Parkway
Syracuse New York 13221
315/432-6000

September 20, 1993

The Honorable Charles B. Rangel
United States House of Representatives
2252 Rayburn House Office Building
Washington, DC 20515-3215

Dear Congressman Rangel:

On behalf of Carrier Corporation, the world's leading air conditioning and heating equipment manufacturer, I am writing to urge your opposition to any new taxes on hydrocholorofurocarbons (HCFCs) should such measures be introduced for your consideration.

HCFCs, chemical used in the refrigeration and air conditioning process, are currently utilized as temporary replacements to chlorofurocarbons (CFCs) which are known to cause damage to the Earth's protection ozone layer. HCFCs are considered a transitional refrigerant until alternatives are further enhanced and developed which will not cause ozone depletion. CFCs will be banned from production starting January 1, 1996 and HCFCs will be phased out starting in 1996 with a ban on consumption and production in 2030.

Any taxes now on HCFCs would be detrimental because:

- According to the United Nations Environmental Programme (UNEP), HCFCs are essential bridging compounds that must be commercialized to allow for the rapid phaseout of the more ozone damaging CFCs. UNEP studies show HCFCs are 89% to 98% safer to the ozone layer than CFCs.
- The air conditioning and refrigeration industry should not be penalized for undertaking a transition away from CFCs. Any new HCFC fax could divert resources from developing refrigeration alternatives that do not damage the ozone layer.

As a matter of corporate policy, Carrier has chosen hydroflurocarbons (HFCs), the primary alternative known today, as its refrigerant of choice as it does not deplete the ozone layer. While incorporating HFCs wherever and whenever we can, HCFCs are still needed in transition so the industry can adapt all products to new chemical technologies.

Should any HCFC taxes be introduced, Carrier hopes your will consider these arguments in opposition.

Sincerely,

E. Baily

Edward A. Baily
Vice President
Government & Industry Relations

Select Revenue Measures Subcommittee
House Ways and Means Committee
Hearing on Miscellaneous Revenue Issues
September 23, 1993

STATEMENT OF STANLEY L. WACHMAN, PRESIDENT
CETYLITE INDUSTRIES, INC.
RE: PROPOSED HCFC TAX

On behalf of Cetylite Industries, Inc. I am pleased to submit our views on a proposal to tax hydrochlorofluorocarbons (HCFCs).

Cetylite manufactures a prescription aerosol-propelled topical anesthetic spray under the name CETACAINE®. CETACAINE® is indicated for use on all accessible mucosa (except eyes) to control pain and suppress the gag reflex, i.e., during otolaryngeal procedures, such as laryngoscopies, bronchoscopies, endoscopies, and the like. CETACAINE® currently uses a unique blend of 15 percent hydrochlorofluorocarbon (HCFC) 152a with 55 percent CFC 11 and 30 percent CFC 114. The critical importance of CETACAINE® in allowing doctors to perform life-saving medical procedures lead to its designation as an "essential" product. Thus, it is exempt by both the Environmental Protection Agency (EPA), see 58 Fed. Reg. 4768, 4794 (January 15, 1993), and by the Federal Food and Drug Administration (FDA), see 21 C.F.R. § 2.125(e)(8), from the ban on the use of CFCs as an aerosol propellant.

Cetylite is currently investigating a variety of alternatives (including hydrofluorocarbons (HFCs) as well as HCFCs) to the use of CFCs in its formula. Cetylite plans to switch as soon as a safe and effective alternative is found which meets the rigorous health and safety criteria which all drug ingredients must meet. Until such time as proven alternatives are available, Cetylite must continue to use CFCs. And, patient safety must be paramount in making decisions about any ingredients.

HCFCs provide significant environmental benefits over CFCs, as their ozone depletion potential is significantly lower then that of CFCs. We believe that the federal government should do all in its power to encourage a transition to these environmentally improved chemicals, especially given current encouraging data indicating that ozone levels will stabilize much more quickly than originally anticipated. See Washington Post April 15, 1993, page A1. To stigmatize HCFCs by putting them in the same category as CFCs is counterproductive to these transition goals, and Cetylite opposes any such tax.

Indeed, Cetylite opposes taxing ozone-depleting chemicals used in critical life-saving medical products, like CETACAINE®. We note that current law specifies that chemicals used for sterilizing medical instruments and as propellants in metered dose inhalers are subject to a reduced tax (see Public Law 102-486, October 24, 1992), § 1932(b). There is no reason why medical products like CETACAINE® should be subject to the full tax liability on the CFCs or other ozone-depleting chemicals they use, while products like sterilants and metered dose inhalers are subject to a reduced rate, since all those products are essential for patient well-being. To the extent that HCFCs are subject to a tax, now or in the future, we urge that favorable tax treatment be extended to all medical products, not just chemicals used for sterilizing medical instruments and those used as propellants in metered dose inhalers.

At present, the Congress is ready to evaluate ways to improve our health care system and contain costs. We urge you to avoid any action which will make essential medical technology more expensive for the many patients who rely on it, and more difficult for medical product manufacturers who are attempting to meet patient needs by producing products in an environmentally responsible manner.

Cetylite appreciates the opportunity to submit these views.

Statement of

Jared O. Blum
President of the Polyisocyanurate Insulation
Manufacturers Association

Regarding

Miscellaneous Revenue-raising Proposals

Before the

Subcommittee on Select Revenue Measures
Committee on Ways and Means
United States House of Representatives

September 22, 1993

SUMMARY

The Polyisocyanurate Insulation Manufacturers Association (PIMA) is pleased to submit the following written statement on potential legislation to raise revenues through a tax on hydroclorofluorocarbons (HCFCs). PIMA urges the Ways and Means Committee to reject an HCFC tax. Such a tax could devastate the rigid foam insulation industry, which would cause U.S. energy consumption to increase by up to 75 million barrels of oil per year and result in increased CO2 emissions of over 100 billion pounds per year. Moreover, the tax would not improve ozone protection, and it would actually hurt the environment. Accordingly, any proposal to tax HCFCs should be rejected.

INTRODUCTION

PIMA consists of associated manufacturers of energy efficient polyisocyanurate insulation board (otherwise referred to rigid foam insulation) and suppliers. Our organization has worked cooperatively with the U.S. Environmental Protection Agency and the U.S. Department of Energy to expedite the phaseout of CFCs in our products and to develop new substitute products containing HCFCs that offer the same level of performance that makes rigid foam insulation one of the most energy efficient insulation products on the market.

Rigid foam insulation represents the state-of-the-art in energy efficient insulation for residential and commercial buildings. The Department of Energy analysis shows that rigid foam insulation has saved 1.2 billion barrels of oil in the

last decade. Rigid foam insulation is used in over 60 percent of new commercial roof construction, 40 percent of new residential construction, and most reinsulation of existing commercial building roofs. Rigid foam is simply the most efficient insulation material of any of the insulations in the construction market and is still priced competitively with less energy efficient roof and wall insulating products in the cost-driven construction industry.

In 1989, members of PIMA, the Polyisocyanurate Insulation Manufacturers Association, announced that by December 31, 1993 they would eliminate the use of chlorofluorocarbons ("CFCs"), which are an expansion agent of rigid foam insulation, several years sooner than required by the Montreal Protocol or the Clean Air Act. On June 25, 1993, PIMA announced at a press conference that the industry would complete the transition ahead of the projected schedule. In addition, the extruded polystyrene insulation producers, an important member of the rigid foam insulation industry, also began their conversion away from CFCs in 1989 and were completely converted during 1992.

Over the past several years, the U.S. Environmental Protection Agency and the U.S. Department of Energy have supported PIMA's efforts, through a joint research project at Oak Ridge National Labs, to develop rigid foam insulation that does not contain CFCs. As a relatively small industry group (approximate 1991 gross sales of $500 million), the capital and human resources of PIMA members allocated to this transition have been monumental. As a result of these cooperative efforts, a substitute product has been developed using hydrochlorofluorocarbons ("HCFCs") as a replacement for CFCs.

Use of HCFCs in foam will result in the dramatic environmental benefit of an over 89 percent reduction in ozone depletion potential as compared to foam containing CFCs. In recognition of the importance of rigid foam insulation, EPA, consistent with the Clean Air Act and the United Nations Environmental Programme, has authorized the use of HCFCs by this industry, to allow time for completely ozone depletion-free substitutes to be discovered and developed.

CONGRESSIONAL SUPPORT FOR ENERGY EFFICIENT RIGID FOAM INSULATION

Congress has played a critical role in the successful transition from CFCs to environmentally preferable substitutes such as HCFC-141b. Of special significance are the following:

- In December 1989, Congress enacted a tax on certain ozone depleting chemicals, primarily CFCs, to encourage the phaseout of these chemicals pursuant to the Montreal Protocol. In establishing the tax, Congress acknowledged the energy benefits of CFC-containing rigid foam insulation. The rigid foam insulation industry was granted a four year reduction in the tax rate which, if applied in full to the industry, would have made the price of rigid foam insulation products noncompetitive, resulting in a virtual elimination of the industry and a substantial national energy penalty.

- In subsequent tax increases on ozone depleting chemicals in 1990 and 1992, Congress retained the reduced rate for rigid foam insulation.
- In further recognition of the importance of rigid foam insulation, Congress excluded this product from certain product bans included in the stratospheric ozone protection provisions of the Clean Air Act Amendments of 1990.
- During the last session, Congress chose not to adopt a proposal that would have taxed HCFCs, recognizing that such a tax would be counterproductive to an expedited phaseout of CFCs, and would hurt the environment.

PIMA RECOMMENDATIONS TO CONGRESS

PIMA urges the Committee to reject inclusion of an HCFC tax in its revenue proposals.

An HCFC tax would penalize companies that have made huge investments to switch out of CFCs. These companies are already subject to a phaseout schedule under the Clean Air Act and international agreement. Moreover, monies that could go to fund alternatives research will be diverted by the tax.

If, however, an HCFC tax is adopted, it should not apply to rigid foam insulation. Such a tax on this product is counterproductive to achieving important fiscal, environmental, and energy goals.

An HCFC tax would increase the price of rigid foam insulation. The rigid foam insulation industry would have to increase the price of insulation products if HCFCs were subject to tax in order to cover costs. The insulation market is highly competitive and has required manufacturers to tightly control costs. There is no ability to absorb additional taxes without increasing the price of rigid foam insulation.

An HCFC tax could jeopardize the viability of rigid foam insulation producers. A 1993 Price Waterhouse study found that the increase in the price of rigid foam insulation attributable to an HCFC tax would result in a potentially devastating loss in sales for this type of insulation, up to 66 percent over the 1994-1998 period depending on the tax proposal. Moreover, because this industry would be decimated, little tax revenue would be raised from this segment.

Less costly and inferior insulation products would be used resulting in an increase in national energy consumption. The Price Waterhouse study, utilizing Oak Ridge National Lab's data, concluded that national energy consumption would increase by up to 379 million barrels of oil over the 1994-1998 period depending on the HCFC tax proposal. The global warming penalty of this increased energy consumption is up to 535 billion pounds of carbon dioxide emissions. In addition, the decreased use of HCFCs would not result in an appreciable improvement of the stratospheric ozone layer. Net result of an HCFC tax on rigid foam insulation: energy efficiency will be hurt, the environment will suffer, and jobs in the rigid foam insulation industry will be lost.

COMMENTS ON TESTIMONY OF OTHER PARTICIPANTS AT THE HEARING

Testimony by Dawn Erlandson, Director of Tax Policy for Friends of the Earth, leaves the impression that there are substitutes for HCFCs currently available for all uses. In fact, no such substitutes for HCFC-141b are presently known for use in rigid foam insulation. Recognizing the need to provide adequate time to discover and commercially develop the next generation of blowing agents, EPA has set a December 31, 2002 phaseout date for HCFC-141b in rigid foam insulation. Even while we have just begun producing rigid foam insulation with HCFC-141b, PIMA members and other companies are already investing significant resources to meet EPA's HCFC-141b phaseout deadline. As discussed above, any tax on HCFCs for this industry would be counterproductive and would seriously jeopardize this essential energy conserving industry.

PIMA welcomes this opportunity to submit these comments. Members of PIMA and I would be happy to meet with members of the Committee and staff to provide further information or answer any questions that you may have.

The Society of the Plastics Industry, Inc.

1275 K Street, N.W., Suite 400
Washington, D.C. 20005-4006
(202) 371-5200
FAX (202) 371-1022

September 23, 1993

The Honorable Charles B. Rangel
Chairman
House Select Revenue Measures Subcommittee
1105 Longworth House Office Building
Washington, D.C. 20515

Dear Chairman Rangel:

The Society of the Plastics Industry, Inc. (SPI), is pleased to submit the following comments, and requests they be included in the September 23, 1993 Subcommittee hearing record on revenue raising options. Specifically, SPI opposes the addition of hydrochlorofluorocarbons (HCFCs) to the list of taxable items as a revenue raising measure.

SPI is the national trade association for, and official voice of, the plastics industry. Founded in 1937, our 2000 members represent the industry's raw material suppliers, processors, packagers and equipment manufacturers. SPI has been a leading voice in communicating, at the federal, state and local levels, support for an effective and global approach toward ozone protection. Yet, we continue to work toward achieving a fair and level playing field for US industry to compete in the global market.

SPI strongly believes that HCFCs are part of the long-term solution toward phasing out ozone-depleting chemicals. Toward this end, we fully support international efforts, through the Montreal Protocol on Substances that Deplete the Ozone Layer, to have industry phase-out the use of these chemicals as quickly as is feasible. Domestically, the Environmental Protection Agency (EPA) is working now on a final proposal which will accelerate the phase-out schedule of ozone-depleting chemicals as provided for under section 606 of the Clean Air Act.

With these two mechanisms already in place and working well, SPI sees little need to impose an excise tax on HCFCs for the following reasons:

1. **The establishment of an HCFC tax is not necessary to encourage industries to shift from HCFCs.**

Every major industry, the plastics industry included, is working diligently to identify completely non-ozone depleting chemicals. No greater incentive is needed than to have time certain phaseout dates for chemicals currently in use. Most of the plastics industry, including the important foam insulation (polyurethane and extruded polystyrene) sector, has switched from CFCs to other chemicals, such as HCFCs. HCFCs are the only available alternatives for these insulation products, at present, and are viewed as vital, transitional compounds.

If a tax is now levied against these compounds, it will do nothing but rob industry of valuable research and development dollars that are needed at this critical juncture to find the next generation of environmentally improved compounds. Industry needs resources to develop these safer alternatives.

2. **Foam insulation offers consumers an energy efficient product.**

Energy efficient foam insulation relies on the use of HCFC blowing agents in this transition period, just as these products previously relied on CFCs. The Clean Air Act Amendments and the current CFC tax laws recognize the vital role that foam insulation products play in advancing energy efficient objectives. The benefits of foam insulation could potentially be lost if a tax is levied against an integral part of the product. We urge the Congress to recognize the essentiality of this product in achieving and promoting national energy savings objectives.

According to a recent Price Waterhouse Study, "An Analysis of the Energy and Environmental Effects of an HCFC Tax," (copy attached for the Record), "Imposition of a tax on HCFCs used in rigid foam insulation would have a number of adverse environmental effects." The report states:

> Based on Oak Ridge National laboratory data, the use of less thermally efficient insulation as a substitute for rigid foam in buildings would increase national energy consumption by the equivalent of 44-379 million barrels of oil over the 1994-1998 period. Carbon dioxide emissions would increase by 63-535 billion pounds over the period as a result of the additional energy consumption.

Further, the analysis says: "Taxing HCFCs used in rigid foam insulation would have a negligible effect on stratospheric ozone." From a study performed by the Atmospheric and Environmental Research, Inc. on chlorine loading under alternative phaseout dates, the report concludes that "...that taxation of HCFCs used in rigid foam insulation would have almost no impact on stratospheric chlorine loading."

SPI further believes that if a tax is levied on HCFC compounds, there should be an exemption for these compounds when used for foam insulation purposes. This precedent was established in 1989 when the CFC tax was imposed.

3. Imposition of a tax on HCFCs will compromise EPA's efforts to promote use of environmentally preferable chemicals.

The EPA has worked diligently to promote acceptance of HCFCs and encourage their short-term use as environmentally acceptable substitutes to CFCs. The Agency's Significant New Alternatives Policy (SNAP) Program identifies HCFCs as acceptable substitutes for CFCs in a variety of applications, including foam insulation. Subjecting these chemicals to the same tax as other ozone-depleting compounds sends a mixed message. We do not believe that the stratospheric ozone protection objectives which Congress established under the Clean Air Act Amendments, and which EPA is implementing, will be advanced by subjecting environmentally preferred chemicals, like HCFCs, to the same tax treatment as CFCs

SUMMARY

In sum, we ask the Subcommittee members to re-think the need to add HCFCs to the list of taxable compounds. Additionally, we ask the Members to please work with industry and other governmental entities in encouraging the transition to completey non-ozone depleting chemicals, by allowing industry the needed time and resources.

If you have any questions or would like to further discuss this issue, I would be happy to comply or facilitate a meeting between industry and your office, as appropriate. We look to your leadership to give these comments every consideration.

Sincerely,

Maureen A Healey

Maureen A. Healey
Director
Federal Environment and
Transportation Issues

cc: Rep. Mel Hancock
Ranking Minority Member
House Select Revenue Measures Subcommittee
1106 Longworth House Office Building

Rep. Dan Rostenkowski
Chairman
House Ways and Means Committee
1102 Longworth House Office Building

Rep. Bill Archer
Ranking Minority Member
House Ways and Means Committee
1106 Longworth House Office Building

Full Select Revenue Measures Subcommittee

[ATTACHMENT HAS BEEN RETAINED IN THE COMMITTEE FILES.]

**The Society of the
Plastics Industry, Inc.**

1275 K Street, N.W., Suite 400
Washington, D.C. 20005-4006
(202) 371-5200
FAX (202) 371-1022

September 24, 1993

The Honorable Charles B. Rangel
Chairman
House Select Revenue Measures Subcommittee
1105 Longworth House Office Building
Washington, DC 20515

Dear Chairman Rangel:

The Society of the Plastics Industry, Inc. respectfully requests the following additional comments be included in our testimony which was submitted for the September 23, 1993 Subcommittee hearing record on revenue raising options.

SPI would like to address two additional points:

1. **Economic analyses** have shown that foam insulation products, especially polyurethane and polyisocyanurate foams, are very negatively affected by increases in HCFC blowing agent costs. Such increases, based on a pass-through of the proposed taxes, would lead to a 10 to 50% reduction in foam insulation use by consumers, depending on the tax rate for the HCFCs.

4. **Impact on national energy consumption**. Since foam insulation products blown with HCFCs are the most efficient commercial materials ORNL (Oak Ridge National Laboratory) evaluated the impact of the use of substitutes on national energy consumption. ORNL found that use of less efficient insulations would require several hundred million barrels of additional heating oil over three years with the concurrent increase in carbon dioxide emissions of 300 to 600 billion pounds.

SPI encourages the Congress to recognize again the essentiality of these products in achieving energy efficiency and promoting energy conservation. We anticipate you will make every effort to include our additional comments in the hearing record.

If you have any questions, please contact me at 202/371-5219.

Sincerely,

Maureen A. Healey

Maureen A. Healey
Director
Federal Environment and
Transportation Issues

TESTIMONY SUBMITTED BY WHIRLPOOL CORPORATION

SEPTEMBER 23, 1993

Whirlpool Corporation, the world's largest manufacturer of major home appliances is gravely concerned regarding deliberations by the Ways and Means Committee (Subcommittee on Select Revenue) to create a hydrochlorofluorocarbon (HCFC) tax. We oppose such a tax for several reasons. These reasons are as follows:

Public Benefits:

HCFC-22 is used as a refrigerant in room air conditioners, dehumidifiers, and other products. HCFC-141b is to be used as the foaming agents in refrigerators and freezers. It is important to know that the foaming agents and refrigerants which contain no HCFC's are still years away. Although much testing is planned or underway, both at Whirlpool and within the appliance industry, much remains to be done. We want to insure maximum public benefit in terms of health, safety, reliability, quality, and system performance. We also want to be absolutely sure that any product we market meets or exceeds the highest customer expectations. This can only be accomplished by a thoughtful and systematic testing process, not by a punitive tax.

Consumer Cost:

The appliance industry held the consumer price index (CPI) for major home appliances to a 2% increase between 1982 and 1993. During the same period there was a much more substantial increase of 44.9% in the CPI for all goods and services combined. An HCFC tax is a levy which will have an adverse impact on the CPI for major home appliances. On the human level, it could be especially onerous to the poor and lower middle income consumers who can least afford likely increases in retail prices. The net affect of this tax is to add cost with no commensurate consumer benefit.

Environmental Impact:

- Current proposals could force manufacturers to consider delaying current plans to phase out of CFC-11 (foaming agent). The combined risks of warranty, liability and increased costs for completing the transition to HCFC-141b could produce an inducement for manufacturers to continue using CFC's for the next couple of years rather than phase into substantially less ozone depleting alternatives.

- Some of the foaming agent alternatives to HCFC's (like hydrocarbons [HC's]) are not as energy efficient. For example, we know that with current technology the HC's carry about a 10% energy penalty when used in place of HCFC-141b. This in turn contributes to global warming due to the greater thermal conductivity of this less energy efficient blowing agent. It also makes compliance with minimum DOE energy efficiency standards more difficult and expensive.

Manufacturer Impact:

At a time when other governments seem to be assisting their appliance manufacturers in transitioning away from CFC's, and other ozone depleting compounds, our government is considering punitive taxes in an attempt to prematurely force new technologies into the market. An unintended effect of this tax could be to arbitrarily increase the cost of U.S. manufactured goods which are being sold in foreign markets. This affects a U.S. manufacturer's ability to compete in global markets. Also, since there are currently no proven alternatives to HCFC's, such a tax siphons away resources which manufacturers could use to invest in plant/product environmental and energy efficiency projects. Thus, the production and implementation of new alternatives to HCFC's, or other product innovations to enhance energy efficiency, could be delayed by a reduction in available investment capitol and engineering resources. The net impact of HCFC taxes to Whirlpool could be many millions annually.

Summary:

Whirlpool Corporation has a long history of environmental stewardship. We have been vigorously phasing out CFC's, especially for our high volume products. Your subcommittee may be aware that Whirlpool recently won a Super Efficient Refrigerator Program (SERP) competition among 14 appliance manufacturers to design, produce and market a CFC-free, super high efficiency refrigerator. We have also implemented an aggressive campaign to recapture and recycle CFC's and HCFC's during service and disposal, 2½ years in advance of EPA mandates. Thus, our commitment and our achievements regarding environmental matters are public record.

However, we adamantly **oppose** the imposition of an HCFC tax. We submit that such a tax could act as a deterrent to more rapid phaseout of CFC's. We further submit that such a tax will adversely affect poor and middle income consumers, arbitrarily raise cost, and likely produce an anti-competitive impact on global marketers of U.S. products. We request that your committee **drop** any further consideration of HCFC taxes.

Thank you for the opportunity to comment.

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TESTIMONY OF THE NATIONAL CLUB ASSOCIATION

The National Club Association (NCA) submits the following comments on the House Ways and Means Select Revenue Measures Subcommittee's proposal to deny Internal Revenue Code Section 501(c)(7) tax-exempt status to clubs which engage in discrimination (including gender discrimination) and to deny any preferential tax treatment for tickets to events at these clubs.

The NCA is the trade association representing the legal, legislative and business interests of private social, recreational and athletic clubs. Over 1000 such clubs throughout the country, with an estimated one million members, belong to NCA. Member organizations include country, golf, city, tennis, yacht and athletic clubs. The scope of these club operations range from small clubs with limited membership and facilities to larger, full-scale operations with dining and extensive recreational facilities.

RIGHT OF ASSOCIATION

NCA believes the proposal would violate the constitutionally protected right of freedom of association and the privacy of private club members by utilizing the tax code to coerce them into modifying their club's membership practices. It would be an abuse of the tax laws to use them to achieve such unrelated social objectives.

It is not, however, the policy of NCA to endorse discrimination. NCA urges members to articulate and adopt policies of selective membership which fulfill the conceptual goals and purposes of their particular club. Joining a club is not a rejection of those who do not belong. Rather, becoming a member of a private club involves a voluntary joining together of people with similar likes, interests and purpose. It is simply a private decision on how and with whom a private individual will spend some of his or her time in a social and recreational setting.

Freedom of association -- the freedom to associate with the people we choose -- is an important component of our constitution. Private voluntary associations, such as clubs, play an important role in individual self-definition, and foster diversity and pluralism. The freedom to select one's fellow members is the essence of the freedom of association in the context of a private social club. Government intrusion upon membership selection encroaches upon this freedom and alters the self-determining character of the group.

To preclude clubs from forming on the basis of gender will have a negative impact on the many women's clubs that work to serve women and our society at large. Frequently the common bond of their membership, derived in part from either religious, gender, ancestry or ethnic membership qualification, gives them a single-mindedness and common purpose.

A truly private association or club is bona fide nonprofit and to qualify for tax-exempt status must be organized for recreational or other private social purposes. It cannot be a public accommodation because it would lose its tax-exempt status. Thus, the tax-exempt social or recreational club must exclude the general public. The club accomplishes this exclusion by engaging in qualitative and selective membership practices.

Clubs exercise selectivity in the admission of new members to promote conviviality, collegiality and the common social or recreational interests of its members. A truly private association or club is ordinarily open only to members and their guests. It is part of its members' private social lives.

Congress should not confuse "discrimination" with "exclusivity" and "selectivity". A private club has a right to be selective to ensure prospective members will be compatible with existing members. If the private club is genuinely selective in and otherwise meets the strict statutory standards for a private social and recreational club under the Internal Revenue Code, it is by definition an exclusive club. That is, the club "excludes" non-members from its activities because it exists only to serve the social and recreational needs and desires of its members.

Unquestionably, the government has a profound and continuing interest in ensuring nondiscriminatory access to commercial opportunities in our society. That interest does not extend, however, to citizens' private, social lives. Certainly there are two kinds of relationships of citizens – those that are controlled by law and those that are controlled by purely personal choice or social rights. The government's social policies, such as its nondiscrimination policy, applies to public life only, and therefore, does not reach into the private social environment found in clubs.

The U.S. Supreme Court has confirmed that individuals have a constitutionally protected right to decide with whom they may or may not wish to associate in their private organizations. The proposal would threaten other organizations and require them to forfeit their tax-exempt status and rights of privacy and association.

It Is Unwise To Use The Tax Code to Achieve An Unrelated Social Policy

Currently, section 501(i) of the Internal Revenue Code denies tax-exempt status to any private club whose governing documents provide for discrimination against any person on the basis of race, color or religion. If the rights of privacy and association can be denied tax-exempt organizations, other extraneous demands on the tax code face similar results.

For example, could the tax-exempt status of certain religious entities be revoked because they do not allow women to serve at the highest levels of the church hierarchy? The primary purpose of the tax code is to compute and collect taxes, not to make and implement social policy. The fundamental issue is, then, whether the government, through the tax code, should be the arbiter of a national social policy. We do not believe the overwhelming majority of American voters will sanction social engineering as a legitimate role for government.

ADVERSE EFFECTS OF DENYING DEDUCTIBILITY OF TICKETS FOR EVENTS HELD AT CERTAIN CLUBS

The proposal also seeks to deny any preferential tax treatment for tickets to events at clubs which discriminate. This is again an arbitrary use of the tax code to achieve a social goal. Many clubs host charity events and the effect will likely be the disallowance of a deduction for the charitable portion of tickets for sporting events at clubs. This will decrease charitable contributions and have a direct effect on the needed and worthy volunteer work of charities.

The proposal could also have a negative impact on clubs and club employees already hurting from the recent repeal of the deductibility of club dues and the reduction in the deductibility of business meals and entertaining expenses. Decreased revenues to clubs will translate to fewer hours for employees, potential employee layoffs, and a lower demand for the goods and services purchased by the club for member use or consumption.

The Proposal Would Pose Severe Administrative Problems

Conceptually and practically, the determination of whether private facilities discriminate presents complex problems both in terms of enforcement and compliance. Records concerning membership policies and other club practices would have to retained and evaluated. How would discrimination be defined or evaluated? Would the mere fact, for example, that no individuals of certain ethnic groups or religions belong to a club be enough to allege discrimination even though none may have applied or even been interested in joining. It is difficult to ascertain how this could be realistically accomplished without inordinate budget and manpower demands on the IRS Exempt Organizations Division and possibly other government agencies.

Tax-Exempt Status is Not a Government Subsidy

The concept that tax-exempt private clubs are subsidized by the government is a fallacious argument. It is sometimes charged that tax-exempt clubs pay no taxes and therefore are somehow being subsidized by other taxpayers. Clubs do, in fact, pay federal taxes, including employment taxes (FICA-FUTA) on employee payrolls, as well as taxes on unrelated business income. In addition, clubs pay state and local sales and use taxes and often very substantial real and personal property taxes, while enhancing the value of surrounding properties. Furthermore, private clubs typically make minimal demands on public services such as fire and police protection, and schools, with the result that clubs often generate more public revenue than they require in public expenditures.

At a private social or recreational club, the club members utilize their own after-tax dollars, on a collective basis, to further the purposes of the club and the existence of personal contact, commingling and fellowship among members. NCA believes that compelling arguments and precedents suggest that government "privileges" such as tax exemptions are not tax subsidies and cannot be made contingent on the forfeiture of constitutionally guaranteed rights such as freedom of association and privacy, which are manifested in the selective policies of private clubs.

SUMMARY

The NCA believes this proposal would undermine the purpose and nature of private clubs. The freedom to choose one's associates, to form private groups, associations and clubs reflects important values. In our increasingly fragmented, mobile and impersonal world, private groups provide a critical sense of belonging, a sense of fellowship, and a comfortable environment for social interaction which should be free from unwarranted government intervention.

Clubs today are changing without government intervention. There has been a significant change in the culture of the country and in the policies of clubs, stimulated by the suggestion to clubs that they base their admission policies on individual characteristics, such as congeniality and reputation. Clubs in the 1990s have, with some exception, made the appropriate changes not only in the documentation of their policies but actively in their openness to membership. NCA has supported these changes.

How much more lively, interesting, diverse and democratic our lives are because we can and do belong to a wide range of single-sex, single-race, single-ethnicity or single-interest associations and clubs, rather than being forced into government-regulated and mandated diverse membership associations.

The proposal before the Subcommittee today represents an attempt to have the government dictate the private lives of its citizens. It represents an abusive and coercive use of the taxing power to achieve social change. As such, the NCA asks the Subcommittee to reconsider this legislative proposal.

Written Statement of the National Panhellenic Conference (NPC), National Pan-Hellenic Council Inc. (NPHC), and the National Interfraternity Conference (NIC)

Mr. Chairman,
and members of the subcommittee, on Select Revenue Measures, Committee on Ways and Means, U.S. House of Representatives:

We are pleased to have this opportunity to present the perspective of our organizations on a proposal before the subcommittee to deny Code section 501(c)(7) status to clubs that engage in discrimination (including gender discrimination). Our interest and concern in this proposal derive from the nature and tradition of our organizations based on gender.

While it is our understanding through a discussion with Ways and Means Committee staff that the intent of this proposal is not to affect in any way the organization, operation, or status of American college fraternities and sororities, we, nevertheless, would like to offer comments for the record that may assist the subcommittee in clarifying its intent, as well as in preserving our current status under law.

Position:

Our position on this issue is two faceted. First, we request that the subcommittee clarify its intent not to inadvertently include our organizations in the proposal. In short, we request that fraternities and sororities be specifically excluded from the proposal.
Second, if this be the appropriate time and legislative vehicle, we request that fraternities and sororities be assigned a separate tax identification status that reflects their uniqueness.

These two requests reflect our current status under the law, including the specific exemption provided to us under Title IX of the Education Amendments of 1972 and related regulations (see attached.)

Background:

The 97 American college fraternities that are members of the NPC, NPHC, and the NIC are serving nearly 1,000,000 students on over 800 college and university campuses in the United States. By virtue of their membership, these students receive assistance in scholarship, leadership development, community service, and student housing in a friendly and supportive environment while on campus.

Current research shows that members of fraternities and sororities are more likely to involve themselves in other extracurricular activities and have a greater likelihood of graduation, thus at the same time both promoting and demonstrating the value of learning experiences outside the classroom. In a time of shifting and unsteady family structures, college fraternities and sororities more than ever before are surrogate families for their members. Moreover, an ever increasing volume of respected research has established the value of single-gender educational experiences in the personal development of college students, including aspects such as self-esteem and leadership. Finally, research also establishes that fraternity sorority alumni are significantly more supportive of their alma maters.

Men's and women's fraternities and sororities are not organized like "clubs" that ordinarily provide members with dining, tennis, golf and entertainment facilities, or that have the same mission as those organizations targeted by the proposal under review. Our reasons for existing, our goals, and the results from operation are entirely different than those of "clubs" that are purely social. We emphasize an educational and leadership developmental mission.

American college fraternities and sororities find themselves unfortunately clustered with these other clubs for purposes of tax identification, 501(c)(7) *Social Clubs*. That is why we request a separate tax identification that more accurately reflects our uniqueness.

It is our fervent hope that it is not the intent of the subcommittee to include American college fraternities in its consideration of this proposal to deny 501(c)(7) status from clubs. The result would be detrimental to collegians and to institutions of Higher Education that host these worthwhile student organizations.

Summary:

We look to the subcommittee for clarification of this proposal so that the record and legislation reflect the exclusion of fraternities and sororities. We look to the subcommittee for the creation and inclusion of a separate tax identification status for fraternities and sororities. Should the subcommittee decide to add such a status, we would be very pleased to offer drafting and advisory assistance.

Thank you very much for the opportunity to present the views and position of the National Panhellenic Conference, the National Pan-Hellenic Council Inc., and the National Interfraternity Conference. Our organizations would welcome the opportunity to appear in person before your subcommittee, or provide additional information should you request it. Thank you.

Harriet B. Macht

Harriett B. Macht, Chairman
National Panhellenic Conference

Daisy Wood

Daisy Wood, President
National Pan-Hellenic Council, Inc.

Robert D. Lynd

Robert D. Lynd, President
National Interfraternity Conference

REC'D NIC
JUN 18 1975

FINAL TITLE IX REGULATION IMPLEMENTING EDUCATION AMENDMENTS OF 1972

PROHIBITING SEX DISCRIMINATION IN EDUCATION

Effective Date: July 21, 1975

U.S. DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE/Office for Civil Rights alleviated by any rule or regulation of any organization. club. athletic or other league, or association which would render any applicant or student ineligible to participate or limit the eligibility or participation of any applicant or student. on the basis of sex. in any education program or activity operated by a recipient and which receives or benefits from Federal financial assistance.

(Secs. 901. 902. Education Amendments of 1972. 86 Stat. 373. 374: 20 U S.C. 1681. 1682)

§ 86.7 Effect of employment opportunities.

The obligation to comply with this Part is not obviated or alleviated because employment opportunities in any occupation or profession are or may be more limited for members of one sex than for members of the other sex.

(Secs. 901. 902. Education Amendments of 1972. 86 Stat 373. 374: 20 U S.C. 1681. 1682)

§ 86.8 Designation of responsible employee and adoption of grievance procedures.

(a) *Designation of responsible employee*. Each recipient shall designate at least one employee to coordinate its efforts to comply with and carry out its responsibilities under this part. including any investigation of any complaint communicated to such recipient alleging its noncompliance with this part or alleging any actions which would be prohibited by this part. The recipient shall notify all its students and employees of the name. office address and telephone number of the employee or employees appointed pursuant to this paragraph.

(b) *Complaint procedure of recipient*. A recipient shall adopt and publish grievance procedures providing for prompt and equitable resolution of student and employee complaints alleging any action which would be prohibited by this part.

(Secs. 901. 902. Education Amendments of 1972. 86 Stat 373. 374: 20 U S C 1681. 1682)

§ 86.9 Dissemination of policy.

(a) *Notification of policy*. (1) Each recipient shall implement specific and continuing steps to notify applicants for admission and employment. students and parents of elementary and secondary school students. employees. sources of referral of applicants for admission and employment. and all unions or professional organizations holding collective bargaining or professional agreements with the recipient. that it does not discriminate on the basis of sex in the educational programs or activities which it operates. and that is required by title IX and this part not to discriminate in such a manner Such notification shall contain such information. and be made in such manner. as the Director finds necessary to apprise such persons of the protections against discrimination assured them by title IX and this part. but shall state at least that the requirement not to discriminate in education programs and activities extends to employment therein. and to admission thereto unless Subpart C does not apply to the recipient. and that inquiries concerning the application of title IX and this part to such recipient may be referred to the employee designated pursuant to § 86.8. or to the Director.

(2) Each recipient shall make the initial notification required by paragraph (a) (1) of this section within 90 days of the effective date of this part or of the date this part first applies to such recipient. whichever comes later. which notification shall include publication in: (i) Local newspapers: (ii) newspapers and magazines operated by such recipient or by student. alumnae. or alumni groups for or in connection with such recipient; and (iii) memoranda or other written communications distributed to every student and employee of such recipient.

(b) *Publications*. (1) Each recipient shall prominently include a statement of the policy described in paragraph (a) of this section in each announcement. bulletin. catalog. or application form which it makes available to any person of a type described in paragraph (a) of this section. or which is otherwise used in connection with the recruitment of students or employees.

(2) A recipient shall not use or distribute a publication of the type described in this paragraph which suggests. by text or illustration. that such recipient treats applicants. students. or employees differently on the basis of sex except as such treatment is permitted by this part.

(c) *Distribution*. Each recipient shall distribute without discrimination on the basis of sex each publication described in paragraph (b) of this section. and shall apprise each of its admission and employment recruitment representatives of the policy of nondiscrimination described in paragraph (a) of this section. and require such representatives to adhere to such policy.

(Secs. 901. 902. Education Amendments of 1972. 86 Stat. 373. 374: 20 U.S C. 1681. 1682)

Subpart B—Coverage

§ 86.11 Application.

Except as provided in this subpart. this Part 86 applies to every recipient and to each education program or activity operated by such recipient which receives or benefits from Federal financial assistance.

§ 86.12 Educational institutions controlled by religious organizations.

(a) *Application*. This part does not apply to an educational institution which is controlled by a religious organization to the extent application of this part would not be consistent with the religious tenets of such organization.

(b) *Exemption*. An educational institution which wishes to claim the exemption set forth in paragraph (a) of this section. shall do so by submitting in writing to the Director a statement by the highest ranking official of the institution. identifying the provisions of this part which conflict with a specific tenet of the religious organization.

(Secs. 901. 902. Education Amendments of 1972. 86 Stat. 373. 374 20 U.S C 1681. 1682)

§ 86.13 Military and merchant marine educational institutions.

This part does not apply to an educational institution whose primary purpose is the training of individuals for a military service of the United States or for the merchant marine.

(Secs 901. 902. Education Amendments of 1972. 86 Stat 373. 374. 20 U.S C. 1681. 1682)

§ 86.14 Membership practices of certain organizations.

(a) *Social fraternities and sororities*. This part does not apply to the membership practices of social fraternities and sororities which are exempt from taxation under Section 501(a) of the Internal Revenue Code of 1954. the active membership of which consists primarily of students in attendance at institutions of higher education.

(b) *YMCA. YWCA.. Girl Scouts. Boy Scouts and Camp Fire Girls*. This part does not apply to the membership practices of the Young Men's Christian Association. the Young Women's Christian Association. the Girl Scouts. the Boy Scouts and Camp Fire Girls.

(c) *Voluntary youth service organizations*. This part does not apply to the membership practices of voluntary youth service organizations which are exempt from taxation under Section 501(a) of the Internal Revenue Code of 1954 and the membership of which has been traditionally limited to members of one sex and principally to persons of less than nineteen years of age.

(Secs 901. 902. Education Amendments of 1972. 86 Stat 373. 374: 20 U.S.C. 1681. 1682: Sec. 3(a) of P L. 93-568. 88 Stat. 1862. amending Sec 901)

§ 86.15 Admissions.

(a) Admissions to educational institutions prior to June 24. 1973. are not covered by this part.

(b) *Administratively separate units*. For the purposes only of this section. §§ 86.15 and 86.16. and Subpart C. each administratively separate unit shall be deemed to be an educational institution.

(c) *Application of Subpart C*. Except as provided in paragraphs (c) and (d) of this section. Subpart C applies to each recipient. A recipient to which Subpart C applies shall not discriminate on the basis of sex in admission or recruitment in violation of that subpart.

(d) *Educational institutions*. Except as provided in paragraph (e) of this section as to recipients which are educational institutions. Subpart C applies only to institutions of vocational education. professional education. graduate higher education. and public institutions of undergraduate higher education.

(e) *Public institutions of undergraduate higher education*. Subpart C does not apply to any public institution of undergraduate higher education which traditionally and continually from its establishment has had a policy of admitting only students of one sex.

(Secs. 901. 902. Education Amendments of 1972. 86 Stat 373. 374: 20 U S.C. 1681. 1682)

Alliance for Justice

A National Association of Organizations Working for Equal Justice

1601 Connecticut Avenue, N W Suite 600 ■ Washington, D C 20009 ■ 202 332-3224

NAN ARON
Executive Director

FRANCES DUBROWSKI
Chair

MEMBERS

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National Women's Law Center
Native American Rights Fund
Natural Resources Defense Council
New York Lawyers for the Public Interest
Public Advocates Inc
Sierra Club Legal Defense Fund
Women's Law Project
Women's Legal Defense Fund

September 20, 1993

The Honorable Charles B. Rangel
United States House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Congressman Rangel:

We are pleased to enclose a letter responding to your August 18, 1993 press release. Our concern is with two of the revenue producing initiatives found in the section on Tax Exempt Entities. These are items numbered 3 and 4:

- A proposal to impose a 30 percent excise tax on expenditures of tax-exempt organizations for lobbying (including amounts paid as salaries and an allocable portion of support costs).
- A proposal to include contacts with regulatory agencies (except local land use agencies) in the definition of lobbying for purposes of the existing restrictions on Code section 501(c)(3).

The more than 80 national, state, and local nonprofit organizations that have signed this letter are opposed to both of these measures for the reasons outlined in the attached letter.

Sincerely,

Nan Aron
Executive Director

Carol Seifert
Deputy Director

September 20, 1993

The Honorable Charles B. Rangel
United States House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures
Longworth House Office Building, Room 1102
Washington, D.C. 20515

Dear Congressman Rangel:

The undersigned organizations, which represent a significant cross-section of charitable and tax exempt organizations, join in opposing the proposed 30 percent tax on lobbying expenditures of tax exempt organizations and the expansion of the definition of lobbying applicable to charitable organizations, both of which were included among the miscellaneous revenue raising proposals recently announced by the Subcommittee.

Congress has previously found that charitable organizations provide critically important information to legislators and, accordingly, has encouraged charitable lobbying by increasing both the amount and scope of permitted activity. Over the past several decades, the nonprofit community has assumed increased responsibilities for the delivery of social services and has played an expanding role in the analysis of public issues. Nonprofit organizations have provided Congress with valuable expertise on subjects as diverse as the dangers of smoking and the effects of the tax law on our poorest citizens. Consider the recent legislative contributions of nonprofits that work on a daily basis with the disabled. Nonprofits, like those which have developed successful child care programs, are often our best incubators for designing new approaches to solving social problems and provide legislators with reliable information on the design and implementation of new programs. Nonprofit organizations also speak for constituencies that otherwise do not have an organized voice. Their thorough and detailed policy analyses make an important contribution to legislative debates. The proposed tax would stifle this valuable flow of information from nonprofit organizations to Congress and state and local legislatures.

Congress has recognized this role as important and no substantial evidence of abuse justifies re-opening this debate. Nor do revenue considerations support this proposal: most exempt organizations will reduce or forego lobbying rather than pay a 30 percent tax. As discussed in greater detail below, for these reasons the Subcommittee on Select Revenue Measures should reject the proposals to impose a tax on the lobbying expenditures of exempt organizations and to broaden the definition of lobbying.

Congress has repeatedly considered federal tax restrictions on lobbying by charities and, in each case, concluded that charitable lobbying should be encouraged, not discouraged by the imposition of penalty taxes.[1] In the mid-seventies, Congress undertook a comprehensive review of the proper role of charities in the legislative process culminating in the addition to the Internal Revenue Code of sections 501(h) and 4911 which established clear guidelines on lobbying by charities, but also imposed penalty taxes for noncompliance with these limits. At that time many Congressional leaders endorsed the participation of charities in the legislative process. Senator Muskie, one of the floor leaders of the bill, described the sector as "a valuable source of information; they can broaden legislators' understanding of proposed legislation, and they can suggest valuable legislative alternatives."[2] In a similar vein, Senator Nelson explained that exempt organizations can "greatly assist all legislators by providing them the benefits of the(ir) experience and knowledge . . . . These groups have much information to contribute and a wide range of helpful experience that could greatly assist the consideration and enactment of this country's laws."[3]

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[1] As recently as last month, in considering the 1993 Omnibus Budget Reconciliation Act, the Conference Committee rejected the Senate's attempt to treat charitable lobbying similar to business lobbying; while maintaining provisions to deter the potential abuse of using charitable organizations for business lobbying, the committee rejected broader reporting obligations and denials of individual deductions (the obverse of tax at the organizational level). Again, in 1987 Congress also considered the lobbying activities of charitable organizations; apparently concluding that excessive lobbying was not widespread, it rejected a proposed blanket tax on managers of charities engaging in excessive lobbying, limiting it to those cases in which the violation was knowing and willful.

[2] 121 Cong. Rec. 42028 (daily ed. December 19, 1975).

The proposal to tax lobbying by exempt organizations fails to address directly any of the widely perceived problems with our current legislative process. Lobbyists, who of course engage in a constitutionally protected activity, have been vilified as the personification of the evil influence of money in politics; accordingly, there is some appeal to taxing, and thereby discouraging, lobbying, even that of nonprofit organizations. If government reform is the goal, however, the better approach would be to focus on honoraria and other gifts which Justice Robert Jackson called the "real evils of lobbying."[4]

The absence of a compelling governmental interest supporting this proposal raises important policy and constitutional considerations. Critically important democratic political values are embodied in the First Amendment provision which forbids Congress from abridging the right of people "to petition the Government for a redress of grievances." Accordingly, Congress should proceed cautiously when considering taxing lobbying activities. Under modern First Amendment jurisprudence, limitations on constitutionally protected political expression must survive strict scrutiny and further a compelling state interest in the least restrictive manner. There is no evidence of corruption on the part of the already highly regulated charitable community to support this intrusion on constitutionally enshrined political speech.

By imposing additional burdens, the proposed tax on lobbying by exempt organizations and the redefinition of lobbying for charitable organizations would reduce their already limited, but valuable, participation in the legislative process. Federal tax law currently subjects charities to strict limits on their lobbying activities and compels costly, burdensome recordkeeping. In addition, to comply with the law that prohibits exempt organizations from lobbying with federal funds, charities must learn yet another set of prohibitions. Finally, current and proposed laws governing registration of lobbyists and reporting of lobbying activities employ still other definitions. Faced with the prospect of a 30 percent tax on lobbying activities, in addition to innumerable, costly recordkeeping and reporting obligations, most charities would reduce or abandon any participation in the legislative process. Accordingly, rather than providing the Treasury with substantial additional revenues, the measure would cause a decline in the quality of legislative debate at both the state and federal level.

The charitable community also opposes extending the definition of lobbying to include contacts with regulatory agencies. Charitable lobbying is already subject to stringent limits; increasing the number of activities subject to these limits will significantly reduce the participation of charities in the public policy arena. Furthermore, government policy argues against these restrictions. The Administrative Procedure Act embodies the principle that administrative agencies benefit from public comment on their proposed actions. Accordingly, the tax code should not limit or tax charities' participation in the regulatory process. As discussed above, current law already restricts self-serving contacts with administrative agencies: efforts to secure government funding may not be financed with federal funds and such activities paid for with private funds must be reported. Finally, equitable considerations require that the Internal Revenue Code not discourage administrative agency participation by charities while not similarly taxing or restricting participation by other segments of society.

This current proposal to expand the scope of charitable activities subject to the definition of lobbying is part of a disturbing trend. Both the OBRA provision to deny deductions for business lobbying and the proposed Lobbying Disclosure Act employ definitions which are broader than those incorporated in sections 501(h) and 4911. The definitions contained in section 4911 were enacted after careful and detailed consideration, including the interplay between these definitions and the expenditure limits. Inflation has now distorted this balance so that fewer activities can be conducted under the expenditure limits.

For all of these reasons, tax penalties should not be imposed on the lobbying activities of charitable organizations. In addition to providing critically important information to legislators, charities are deserving of special protection because they must be limited to public, not private, purposes, and are not accompanied by political contributions and their inherent potential for abuse. Lobbying by nonprofit organizations is an important element of the vital political discourse on which participatory democracy depends. It should not be discouraged, further limited, or taxed.

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[3] 119 Cong. Rec. 5749 (daily ed. February 28, 1973).

[4] United States v. Harriss, 347 U.S. 612, 636 (1954).

Sincerely,

Advocacy Institute
Alliance for Justice
American Arts Alliance
American Association of University Women
American Cancer Society
American Diabetes Association
American Civil Liberties Union
American Foundation for the Blind
American Heart Association
American Library Association
American Licensed Practical Nurses Association
American Red Cross
Association for Healthcare Philanthropy
Baptist Joint Committee on Public Affairs
Bazelon Center for Mental Health Law
Business and Professional People for the Public Interest
CARE
Catholic Health Association
Center for Community Change
Center for Nonprofit Corporations (N.J.)
Center for Law and Social Policy
Center for Population Options
Center to Prevent Handgun Violence
Center for Public Representation
Center for Science in the Public Interest
Children's Defense Fund
Consumers Union
Council for Advancement and Support of Education
Council for American Private Education
Council on Foundations
Economic Policy Institute
Employment Law Center
Epilepsy Foundation of America
Equal Rights Advocates
Family Service America
Food Research and Action Center
Girl Scouts of the U.S.A.
Goodwill Industries of America
INDEPENDENT SECTOR
InterAction
International Physicians for the Prevention of Nuclear War
Juvenile Law Center
Land Trust Alliance
Lawyers' Committee for Civil Rights Under Law
Michigan United Conservation Clubs
NAACP
National Abortion Rights Action League
National Association of College & University Business Officers
National Association of Independent Schools
National Center for Resource Innovations
National Coalition for the Homeless

National Committee for Responsive Philanthropy
National Council of Catholic Women
National Council of La Raza
National Council of Nonprofit Associations
National Easter Seal Society
National Legal Aid and Defender Association
National Multiple Sclerosis Society
National Parent-Teacher Association
National Society of Fund Raising Executives
National Wildlife Federation
National Women's Law Center
Native American Rights Fund
Nebraska Wildlife Federation
North Carolina Wildlife Federation
Older Women's League
OMB Watch
Peace Action
Peace Development Fund
People for the American Way Action Fund
Planned Parenthood Federation of America
Public Citizen
Public Health Institute
Sierra Club
Sierra Club Legal Defense Fund
Tennessee Conservation League
The Association of Junior Leagues International
The Wilderness Society
United States Catholic Conference
United Way of Ameica
U.S. Forum
Washington Council of Agencies
Washington Office on Latin America
Women's Law Project

American
Association
of
Museums

Edward H. Able, Jr.
Executive Director

September 21, 1993

The Hon. Charles Rangel
Chairman
Subcommittee on Select Revenue Measures
1105 Longworth House Office Building
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the more than 8,000 museums in America, I would like to express serious concern over the proposal for a 30 percent excise tax on lobbying expenditures of tax-exempt organizations and the proposal to include contacts with regulatory agencies in the definition of lobbying for purposes of restrictions on 501(c)(3) organizations. Both were included among the miscellaneous revenue raising proposals recently announced by the Subcommittee on Select Revenue Measures.

Under current law, strict regulations govern both the type and amount of activities in which charities may engage: lobbying may not constitute a significant part of their operations, and involvement in political campaigns -- including contributions to candidates and political parties -- is forbidden outright. There is no evidence of widespread abuse to justify imposing new limitations on the entire nonprofit community as opposed to concentrating on enforcement of current law.

Both Congress and the IRS have recently endorsed the participation of charities in the legislative process under tight controls. The 501(h) regulations were issued in 1990 after fourteen years of intensive negotiations: surely they should not be superseded a mere three years later.

Regarding the proposed expanded definition of lobbying activities, many nonprofits have close non-advocacy relationships with agencies. For example, the American Association of Museums (AAM) administers two programs for the Federal government: the Museum Assessment Program for the Institute of Museum Services, and the International Partnerships Among Museums for the United States Information Agency. Surely this activity, which entails close and frequent contact among program staff, should not be defined as lobbying. Moreover, many nonprofits supply expertise of which they are the sole possessors. For example, AAM has

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20005

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(202) 289-1818

worked very closely with the National Park Service to develop regulations implementing the Native American Graves Protection and Repatriation Act of 1990. No other organization can supply such expertise or speak for so many museums affected by the Act.

We suspect that revenue considerations will not support the proposals: since lobbying may not constitute a significant part of their operations, nonprofit expenses on lobbying are bound to be rather small. For example, not one museum maintains its own Federal lobbying office. Most nonprofits operate on very tight budgets and will reduce or forego lobbying rather than pay a 30 percent tax.

As you know, the Oversight Subcomittee is holding a series of hearings on nonprofit issues. With the full and enthusiastic cooperation of Independent Sector, the Subcommittee is exploring issues such as executive compensation, disclosure, and self-inurement. The thrust of the hearings is to find ways to deal with the few who take advantage of their nonprofit status without hurting the vast majority whose integrity is unquestioned. Speaking for museums, I can promise that we would be happy to cooperate with you should you wish to pursue a similar course with respect to nonprofit lobbying.

Let me close by thanking you for your strong support of individual institutions in your district, such as the Studio Museum in Harlem, the Schomburg Center, the Hispanic Society of America, and the Yeshiva University Museum, and for your support and understanding over the years of many issues affecting the larger cultural community.

With best wishes,

Sincerely,

Edward H. Able, Jr.

CENTER
FOR
NON-PROFIT
CORPORATIONS

September 21, 1993

The Honorable Charles Rangel
United States House of Representatives
Committee on Ways and Means
Subcommittee on Select Revenue Measures
Longworth House Office Building, Room 1102
Washington, DC 20515

Dear Congressman Rangel and Members of the Subcommittee:

On behalf of New Jersey's charitable non-profit sector and the 600 dues-paying member organizations of the Center for Non-Profit Corporations, I am writing to express deep concern about recently-announced revenue raising proposals that would impose a 30 percent tax on lobbying expenditures of tax-exempt organizations and broaden the definition of lobbying under the law.

As you know, interactions between charitable organizations and policy makers are already subject to strict federal laws and regulations. Influencing legislation may comprise no more than an "insubstantial part" of a charity's activities. Attempting to influence the outcome of a political campaign is expressly prohibited. Failure to adhere to these standards can result in stiff excise taxes or loss of tax exemption.

However, Congress has consistently recognized the important and unique contributions that the charitable community brings to the public debate. In 1976, Congress passed legislation intended to clarify the "insubstantial" threshold for lobbying by 501(c)(3) public charities and thus encourage charities to lobby within their legal limits.

Clearly, a tax on lobbying expenditures would create a powerful disincentive for most charities from participation in the legislative process. In New Jersey, charities are already forced to maintain two separate sets of records in order to comply with federal lobbying laws and our state's own lobbying registration and disclosure laws and regulations. A 30 percent excise tax, coming on top of already burdensome administrative requirements, will cause many groups to stop lobbying altogether, thus depriving the President and members of Congress of their expertise on important policy issues and the vital perspective of the people non-profits serve.

Furthermore, the revenue-raising potential of this tax proposal is questionable at best. According to the National Center for Charitable Statistics, over 72% of charitable groups have budgets of under $500,000,[1] and simply do not have the "deep pockets" that this option assumes. Secondly, as stated previously, charities will curtail or eliminate lobbying altogether rather than paying the 30 percent tax. If this happens, the real losers will be children, low-income people, the elderly, the mentally and physically disabled, the homeless and other disadvantaged people who rely on non-profits to serve as their primary -- and sometimes their only -- voice in Congress.

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[1] National Center for Charitable Statistics (NCCS) analysis of Form 990 filers, as reported in NCCS, Nonprofit Almanac 1992-1993: Dimensions of the Independent Sector, Jossey-Bass Publishers (San Francisco), 1992.

We are also strongly opposed to a proposal that would include communications with administrative agencies in the definition of "lobbying" with respect to charities. We believe that federal laws that prohibit the use of federal funds to influence the awarding of grants or contracts, and which also require reporting when private funds are used for this purpose, already provide the government and the public with more than adequate protection in this area. Congress deliberately structured the administrative rulemaking so as to require active solicitation of comments on proposed regulations. Obviously, government regulators need the technical expertise and advise of an informed constituency in order to execute statutes effectively. Including administrative contacts in the definition of lobbying will discourage charities from participating in this critical interaction and, we believe, seriously compromise the quality of the regulatory process.

Lobbying by charities, by definition, does not and cannot approach that of other entities that are not subject to the same limitations. For this reason, non-profits are already at a disadvantage in terms of their ability to communicate effectively to policy makers. We have seen no evidence of abuse of the existing laws and regulations that would warrant policies that would effectively silence charities and many of the people they serve.

We respectfully urge you to abandon these proposals. Thank you for your consideration.

Very truly yours,

Linda M. Czipo

Linda M. Czipo
Director of Communications and
Advccacy Services

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September 22, 1993

BY COURIER

The Honorable Charles Rangel, Chairman
Select Revenue Measures Subcommittee
House Ways and Means Committee
1102 Longworth Building
Washington, DC 20515

Re: National Venture Capital Association; Comments on Proposed "Clarification" of Treatment of Subpart F Inclusions for Purposes of Tax on Unrelated Business Taxable Income

Dear Congressman Rangel:

Your subcommittee is currently considering a proposal that, if enacted, would affect the tax treatment of United States pension funds and other tax-exempt organizations ("Exempt Organizations") when they invest in foreign corporations. We represent the National Venture Capital Association ("NVCA"), and have been asked by our client to comment on this proposal. The proposal is of concern to the NVCA because a number of NVCA members are involved in raising capital from Exempt Organizations to invest in corporations organized outside the United States.

Background. The proposed legislation would treat income realized by an Exempt Organization as a result of investing directly or indirectly in a foreign corporation as gross income from an unrelated trade or business if that income (a) constitutes that organization's share of the Subpart F income of a controlled foreign corporation ("CFC") and (b) would constitute gross income from an unrelated trade or business if realized directly by the Exempt Organization. As you know, Exempt Organizations are subject to United States tax under section 511 on their "unrelated business taxable income" ("UBTI"), which consists generally of gross income from an unrelated trade or business (including "unrelated debt-financed income") minus allowable deductions. Although the proposal addresses directly only the treatment of income inclusions with respect to CFCs, its adoption would have an effect (perhaps unintended) on the treatment for purposes of section 512 of income realized by Exempt Organizations as a result of direct or indirect investments in "passive foreign investment companies" ("PFICs").

Many Exempt Organizations condition their investments in venture capital partnerships on obtaining a representation from the partnership to the effect that the partnership will not incur (or will use its best efforts to avoid incurring) income constituting UBTI when reported by any Exempt Organization that is a partner. Treatment of income inclusions under either the CFC or PFIC rules as UBTI to Exempt Organization partners would make it much more difficult for venture capital partnerships to raise money from Exempt Organizations to invest offshore and could also result in unavoidable conflicts of interest between the taxable and tax-exempt partners of such a partnership with respect to certain tax elections that, under the PFIC rules, must be made at at the partnership level.

NVCA's position. The existing CFC rules as they apply to Exempt Organizations are currently under consideration by the Internal Revenue Service and Treasury Department. We believe that the treatment of CFC and PFIC income inclusions for purposes of the rules governing UBTI should be coordinated with the rules governing investments by Exempt Organizations in domestic corporations, and that any revisions of the existing structure should be undertaken only in the context of a broader review of the purposes served by those rules and their application in the context of overseas investments by Exempt Organizations in both CFCs and PFICs. Piecemeal revisions are likely to result in unintended consequences.

In recent discussions with Treasury Department and Internal Revenue Service personnel involved in drafting rulings and regulations dealing with exempt organizations and international matters, it appears that very few are aware of this proposal. No one we contacted had been consulted regarding the purpose or likely effects of the proposal. We strongly suggest that consideration of the proposed legislation be delayed until, at the very least, the views of the governmental agencies most concerned with enforcing the UBTI rules can be obtained and the proposal can be coordinated with existing approaches to CFC and PFIC inclusions by Exempt Organizations.

In particular, we are concerned that adoption of the proposal in its current form would discourage Exempt Organizations from acquiring limited partnership interests in venture capital partnerships that invest overseas, despite the lack of any tax avoidance motive on behalf of these Exempt Organizations. Presumably, the proposal was not intended to curtail this type of investment. For this reason, if the proposal is adopted, we recommend that it first be modified in the manner described below. Some modification is necessary in order to mitigate the adverse impact that the proposal otherwise would have on the ability of United States venture fund managers to raise money from Exempt Organizations to make venture investments overseas, and on the ability of United States pension funds and other Exempt Organizations to diversify their investment portfolios in a reasonable and prudent manner by investing part of their capital in such partnerships without running afoul of the UBTI rules.

DISCUSSION

Unrelated business taxable income: in general. Exempt Organizations are subject to tax on UBTI attributable to "debt-financed property" (e.g., dividends paid on stock acquired with borrowed funds) and on gross income attributable a "trade or business" that is both "regularly carried on" and unrelated to the organization's exempt purpose. Section 512(b) sets forth several types of income that are generally not treated as giving rise to UBTI when realized by an Exempt Organization unless leverage is involved; these include dividends, interest, gains on dispositions of property other than inventory, real property rents, and royalties.

Treatment of deductible payments made by "controlled organizations". Each of these types of income other than dividends realized by an Exempt Organization and attributable to payments made or to be made to that Exempt Organization by a "controlled organization" is treated as gross income from an unrelated trade or business to the same extent as if that income had been realized directly by the Exempt Organization. Under section 512(b)(13), a controlled organization means any corporation controlled by an Exempt Organization, and "control" for this purpose requires direct ownership of at least 80% of the total combined voting power of the controlled organization and at least 80% of all shares of its nonvoting stock. The rationale for the controlled organization rule apparently is to prevent Exempt Organizations from effectively avoiding all taxes on business income by stripping that income out of their controlled subsidiaries through deductible payments to the Exempt Organization parent. Since dividends are not deductible (and therefore can be paid only with after-tax dollars), dividends paid by the controlled subsidiary to its parent do not generate UBTI unless subsidiary stock held by the parent is debt-financed.

Treatment of Subpart F inclusions under current UBTI rules. Under Subpart F, "United States shareholders" of a CFC are subject to United States income tax, on a flow-through basis, on their shares of the "Subpart F income" of the CFC. Historically, the Internal Revenue Service ("Service") has taken the position that Subpart F income realized by an Exempt Organization as a result of its direct or indirect ownership of an interest in a CFC constituted a constructive dividend.[1] Dividends, of course, are excluded from UBTI under section 512(b)(1).

In its most recent private letter ruling on this issue (PLR 9043039 (July 30, 1990)), however, the Service indicated that Subpart F income would be treated as UBTI to the extent that the income would constitute UBTI if received directly by the Exempt Organization. That ruling, which was issued less than four months after a ruling on similar facts that took the opposite view, dealt with income reportable by an Exempt Organization under the CFC rules as a result of its 100% ownership of a "captive" offshore insurance subsidiary. The ruling stated that the characterization of the Exempt Organization parent's CFC inclusions as UBTI or non-UBTI must be based on the nature of the income realized by the controlled corporation; it concluded that the CFC inclusions did not constitute UBTI because the controlled corporation's income consisted of interest, dividends and other non-UBTI income and gains. The ruling gave no indication of why the Service's approach had changed and, since that ruling was issued the Service has released no administrative pronouncements and no additional guidance (public or private) on this issue.

The proposal currently under consideration by your Subcommittee reportedly is based on a similar proposal set forth in section 11408 of H.R. 3299, which was passed by the House in 1989, before the issuance of PLR 9043039. The drafters of that legislation provided no written guidance regarding its purpose. That earlier legislation, and the proposal currently under consideration by your Subcommittee, may be intended to prevent Exempt Organizations from avoiding all tax on income from business operations by causing a business to be conducted through a "controlled" corporation located in a tax-haven jurisdiction.

The threshold for "control" that will result in the imposition of United States tax liability is far lower under the proposed legislation than the 80% threshold set forth in section 512(b)(13) with respect to investments by Exempt Organizations in domestic corporations, however. Because of certain attribution rules applicable for purposes of the CFC provisions, Exempt Organizations that invest in a diversified venture capital partnership may incur UBTI if that proposal is adopted, even though those organizations take no part in the management of the venture capital partnership or its portfolio companies and have no tax avoidance motive.

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[1] See, e.g., PLRs 9027051 (April 13, 1990), 9024086 (March 22. 1990), 9024026 (March 15, 1990), 8922047 (March 6, 1989), 8836037 (June 14, 1988), and 8819034 (February 10, 1988).

Application of CFC proposal to diversified venture capital funds. Section 957(a) defines a CFC as a foreign corporation more than 50% of the stock of which is owned by United States shareholders. Section 951(b) defines a United States shareholder as any United States person who owns 10% of more of the combined voting power of all classes of stock entitled to vote.

For purposes of determining whether a United States person will be treated as a United States shareholder of a foreign corporation, the attribution rules of section 318 apply. These attribution rules provide that stock owned by a partnership is considered as owned proportionately by its partners. Section 958(b)(2) contains a special attribution rule under which a partnership that owns, directly or indirectly, more than 50% of the combined voting power of all classes of stock entitled to vote will be treated as owning 100% of the stock of such corporation. The effect of classification of a foreign corporation as a CFC is that the CFC's United States shareholders must include their pro rata share of the corporation's Subpart F income (as defined in section 952) in gross income as a constructive dividend, whether or not the CFC makes any distributions to the United States shareholder.

Under the attribution rules described above, a United States venture capital partnership that owns more than 50% of the stock of a foreign corporation will be treated as owning 100% of the stock of that corporation and the foreign corporation will automatically qualify as a CFC. In addition, *if an Exempt Organization owns 10% or more of the interests in such a venture capital partnership, that Exempt Organization will be treated as a United States shareholder of the CFC regardless of the actual percentage of stock owned by the venture partnership above the 50% level*. As a result, the Exempt Organization will be required to report its share of the CFC's Subpart F income as UBTI to the extent such income would constitute UBTI if received directly by that Exempt Organization.

Under the CFC proposal, Subpart F income inclusions could be required despite the fact that the Exempt Organization *actually* owns less than a 10% indirect interest in the CFC. This is a significant change from the treatment of "controlled organizations" under current section 512(b)(13). That provision does not treat payments made to an Exempt Organization by a related taxable corporation as UBTI unless the Exempt Organization is in "control" of the taxable corporation within the meaning of Section 368(c), which requires at least 80% direct ownership to establish a "control" relationship. Furthermore, in no event are *dividends* paid by the taxable corporation to the related Exempt Organization recharacterized as UBTI.

Interaction with PFIC rules. The PFIC rules generally require United States taxpayers owning, directly or indirectly, interests in foreign corporations deemed not to be sufficiently involved in conducting active, non-investment businesses to either (a) pay a penalty tax, calculated like interest, when those shareholders receive "excess distributions" from or dispose of stock in the PFIC, or (b) elect under section 1295(b) to be taxed currently on their shares of certain increases in the PFIC's earnings and profits (a "qualifying electing fund" or "QEF" election). When the PFIC statute was enacted, Exempt Organizations with investments in overseas corporations that might qualify as PFICs were concerned that the PFIC rules could cause them to realize UBTI. Those concerns were allayed when the Treasury Department released proposed regulations under section 1291 of the Code.[2]

The proposed regulations provide that an Exempt Organization which is a direct or indirect shareholder of a passive foreign investment company will be subject to the PFIC tax regime _only_ _if_ a dividend from the PFIC would be taxable to that organization under subchapter F. These proposed regulations are consistent with the Service's historical view that Subpart F income inclusions constitute constructive dividends and, consequently, do not give rise to UBTI unless the stock on which that income is paid or accrued is "debt-financed property" as defined in section 512(b)(4). The drafters of those proposed PFIC regulations have indicated that, if the proposed legislation is adopted, this provision of the proposed regulations will be subject to review and likely will be revised.

QEF elections made with respect to PFIC stock held by a United States partnership must be made at the partnership level, and venture capital partnerships investing in PFICs typically make a QEF election to enable their taxable United States partners to avoid the "interest charge" penalty tax. If the Treasury Department takes the position that the adoption of the proposal currently under consideration by your Subcommittee _also_ requires an Exempt Organization owning stock in a PFIC to treat part or all of any PFIC income inclusions attributable to making a QEF election as UBTI on a "look-through" basis (a possibility which we understand has been discussed by regulations drafters), a venture capital partnership would not be able to make a QEF election with respect to any PFIC without causing all Exempt Organization partners to recognize UBTI. This would pit Exempt Organization partners against taxable partners, with the general partner in the middle.

Further, since Exempt Organizations tend to be cautious investors, enactment of the proposed legislation likely would have a negative impact on their willingness to invest in venture funds organized to acquire stock of foreign corporations even _before_ the Treasury Department issued additional PFIC guidance _either_ adopting or rejecting the look-through approach to determining the character of PFIC income inclusions. Finally, application of look-through principles in the PFIC area would have a worse effect on venture capital fund-raising for offshore investments than a CFC look-through rule, since a PFIC rule presumably would apply to all Exempt Organization partners regardless of their percentage ownership in the venture capital partnership.

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[2] Prop. Treas. Reg. section 1.1291-1(e).

Recommended Approach

We believe that the proposal currently before your Subcommittee should be withdrawn from consideration until Congress and the Administration develop a coordinated and consistent approach to the policy issues involved.

If the CFC proposal is adopted, however, we recommend that Exempt Organizations holding interests in diversified venture capital partnerships be excepted from the look-through treatment otherwise required for purposes of determining whether CFC (and PFIC) income inclusions constitute UBTI. Investments made through a diversified partnership should not give rise to the concerns about tax avoidance that apparently constitute the rationale for that proposal.

It would be reasonable to treat a partnership as "diversified" for this purpose if the aggregate bases of the partnership's holdings of such stock and securities of any corporation represented less than 25% of the adjusted bases of the partnership's assets (other than cash and cash items). Of course, no venture capital partnership would be able to satisfy a less-than-25% diversification rule at every moment during its term, especially during its start-up and wind-down phases, and any properly-drafted diversification rule would have to take into account such circumstances. We would be pleased to provide you with draft language if that would be helpful, and to respond to any questions you or your staff might have.

Sincerely,

Dean C. Gordanier, Jr.

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202/296-3671, Ext. 214
800/787-2582
FAX 202/223-5843

Comments of the American Land Title Association on Compliance Proposal to Require Reporting of Additional Information to the Internal Revenue Service with respect to certain real estate taxes

before the
Select Revenue Measures Subcommittee
Committee on Ways and Means
U.S. House of Representatives
September 21, 1993

SUMMARY: The American Land Title Association (ALTA)[1] is submitting this statement in support of: (1) the proposal for consideration before the Subcommittee (here after "the proposal") to require state and local governments to file information returns with respect to real property taxes; and (2) the General Accounting Office (GAO) recommendations to improve state and Internal Revenue Service (IRS) information to taxpayers on the deductibility of state and local real property taxes and user fees. For further information on the ALTA position, please contact Ann vom Eigen, ALTA's Legislative Counsel at (202) 296-3671, Ext. 214.

The proposal and the GAO recommendations would impact only state and local governments and the IRS, thus not directly affecting ALTA membership. However, ALTA members do deal with a limited aspect of this problem. In 1993, ALTA members began sending information to the IRS on real property tax proration amounts at the time of a real estate transaction. We recognize, based on our present experience in closing real property transactions, that there is substantial confusion as to whether items indicated on a tax bill are real property tax payments and\or user fees, and that implementation of the proposal and the GAO recommendations would improve taxpayers' knowledge and understanding of their responsibilities.

Proposal Before the Subcommittee: The proposal generally would require state and local governments to report real property taxes paid by, or refunded to, a taxpayer. State and local governments would report this information to both the IRS and the taxpayer, consistent with current filing requirements for other information returns.

General Accounting Office Recommendations: The General Accounting Office issued a report on January 19, 1993 to the Honorable David Pryor, Chairman, Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Committee on Finance, United States Senate, concerning the extent to which individual taxpayers have overstated the federal deduction for real estate tax payments. The IRS found that individuals overstated their 1988 real estate tax deductions by an estimated $1.5 billion. GAO determined that this was actually an underestimate, based on the fact that individuals (1) deducted user fees, and (2) did not report cash rebates.

The General Accounting Office suggested that to improve voluntary compliance the IRS needs to clearly define user fees, special assessments, and rebates in Form 1040 instructions–such as through definitional explanations, or a worksheet. GAO also suggests enhancing audits, sharing data between levels of governments, and the possibility of states filing information returns on rebates to the IRS and taxpayers. Also, consistent with the proposal, the GAO recommended that Congress consider legislation that would require states to report refunds of real estate taxes.

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[1] The American Land Title Association membership is composed of 2,000 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. These firms and individuals employ nearly 100,000 individuals and operate in every county in the United States.

ALTA Experience: The Tax Reform Act of 1986 (Sec. 1521, P.L. 99-514; I.R.C. Sec. 6045(e)) requires that persons responsible for closing residential real estate transactions report gross proceeds and other information from such transactions to the Internal Revenue Service. The primary obligation for such reporting is placed upon the person (including any attorney or title company) responsible for closing the transaction.

ALTA members, as a result of a recently enacted requirement (Sec. 1939 of the Energy Policy Act of 1992 (P.L.102-486)), currently report information on real property tax proration amounts which are calculated at the time of a sale of residential real estate. Reporting of this information to the IRS was imposed late in 1992, and therefor was not addressed in the General Accounting Office analysis or report.

Real property tax proration amounts are an adjustment made at the time of a real estate closing, to take into account a net payment made by the buyer to the seller of a property to compensate the seller for real property tax payments already made for the time when the buyer will be in possession of a property. These amounts are calculated based on the tax payment already paid by the seller in the year of the transaction. The IRS issued interim guidance on this reporting provision in January, 1993. (Notice 93-4, 1993-4 I.R.B. 7, January 25, 1993.) Specifically, IRS Notice 93-4 provides that the reporting person can enter in Box 5 "appropriate" information from the HUD-1 Uniform Settlement Statement (or comparable form provided at the closing) to report any real property tax allocable to the purchaser. Generally, the amounts contained in the 400 series of the HUD-1 would be reported to the seller in Box 5. It has been ALTA's assessment that the IRS has been accepting a reasonable number taken from the HUD-1 (or comparable form) which represents a credit to the seller for real property taxes which have already been paid. Reporting persons are not required to report estimates developed for tax-in-arrears jurisdictions. We had understood from the IRS that in those instances, Box 5 should be left blank.

ALTA members have found in their experience with this reporting requirement, that there is substantial confusion among taxpayers as to what payments they have made that constitute a tax or a user charge. To a large extent, this confusion is irrelevant to the mechanical function that we perform in submitting information to the IRS on a number negotiated by the seller and buyer prior to their arrival at the closing. However, we can state that persons closing loans and taxpayers are often confused as to whether to include certain items as real property taxes, or to net them out of their calculations. We have encouraged our members to err on the side of over-reporting.

Our members are presently frustrated that the information sent to the IRS on real property tax proration amounts can never be matched to any actual tax payment, and therefor can not be used in the IRS matching program, even if state and local governments shared information. The finding that the real property tax number itself is inaccurate increases our concern, and has caused some of our members to suggest that the real property tax proration reporting requirement be suspended.

ALTA believes that the proposal and the General Accounting Office recommendations are productive approaches. We hope that these approaches could be considered in fact, more productive alternatives to encouraging taxpayer compliance than the present 1099 reporting requirement.

Written Testimony
Submitted for the
Subcommittee on Select Revenue Measures
U.S. House of Representatives Committee on Ways and Means
on

Reporting Certain Information to the IRS Regarding Real Estate Taxes

Submitted by:

Harley T. Duncan, Executive Director
Federation of Tax Administrators
Suite 348
444 N. Capitol St. NW
Washington, D.C. 20001

The Federation of Tax Administrators (FTA) is an association of the principal tax administration agencies in the each of the fifty states, D.C., and New York City. In the past year there have been a variety of suggestions on ways to improve compliance with the federal income tax system that could affect the way states administer their property tax rebate programs. While we understand that these suggestions may have been significantly altered since their original introduction, the Federation appreciates this opportunity to explain more about the state "Circuit Breaker" or "property tax rebate" systems. We want to also explain how the original suggestions would have caused significant administrative problems without producing the desired benefit for the federal government.

In a recent report , *Overstated Real Estate Tax Deductions Need To Be Reduced*, GAO/GGD-93-43, January 1993, the U.S. General Accounting Office recommended that "Congress ... consider legislation that would require states to annually send IRS and taxpayers an information return on any cash rebates for real estate tax payments." The GAO recommendation was based on test work involving two states -- Minnesota and New Jersey -- which found that 57 percent of the taxpayers had failed to properly report property tax rebates paid to them by state government.[1] The report estimated that improper reporting in these two states resulted in lost federal revenues of $25 million and concluded that "*[i]f this noncompliance rate is as high in the other 31 states with rebate programs*, the tax losses could be large enough to justify information reporting...." [Emphasis added.]

The FTA believes that requiring information reports on such property tax rebates would not increase federal revenues substantially. Moreover, it would impose unnecessary costs on state governments at a time when they are struggling to meet increased service demands. The objectives sought by such legislation can effectively be achieved by other means.

The FTA conclusion regarding the efficacy of such information reports is based on the fact that the large majority of state property tax rebate programs are limited to elderly and/or handicapped citizens with relatively modest incomes. These persons would be quite unlikely to itemize their deductions. The circumstances in which there might be an unsatisfactory level of reporting are limited to a relatively small number of state programs, and any such underreporting can be addressed effectively through means other than mandated information reports.

To address the issues raised in the GAO report, the Federation has conducted a survey and analysis of state-financed property tax relief programs. The key data gathered in that exercise are contained in the attached table.

- The FTA analysis identified 36 state-financed property tax relief programs. All but 10 programs are limited to certain types of taxpayers. Generally, they are limited to elderly taxpayers (commonly over age 65) and/or disabled citizens who fall below certain income levels. The other 10 programs are open to all homeowners (and in some cases renters) below a certain income level.

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[1] Property tax rebates must be included in income to the extent that the taxpayer received a tax benefit from the deduction of the taxes in the prior year. Rebates of previously deducted real estate taxes are fully taxable if the previous year's itemized deduction exceeds the standard deduction by at least the amount of the property tax rebate.

- All but six of the 36 relief programs are limited to taxpayers with incomes of $30,000 or less.[2] (See attached table.) In all states, the relief provided is inversely related to the level of income, i.e., the proportion of property taxes offset declines as income rises. Internal Revenue Service statistics indicate that less than 11 percent of taxpayers with incomes of $30,000 or less itemize deductions on their tax return. Thus, an information reporting requirement would be essentially meaningless in 30 of the 36 states involved. There would still be substantial costs to design, develop and test the systems necessary to identify those recipients requiring an information report.

- The six states with an income limit in excess of $30,000 paid a total of $1.3 billion in relief in 1991. Of this, about $170 million was paid to renters[3] who, by definition, would not have deducted real estate property tax payments. Of the remaining relief, $1.02 billion was paid in two states -- Michigan and New Jersey.[4]

- The average relief payment is about $300 which is one-half the level of payment allowed before a 1099-MISC is required.

As is evident, the basic proposition underlying the GAO recommendation (i.e., if underreporting is as widespread in all states as in New Jersey and Minnesota, then the Congress should consider the information reporting requirement) is not met. Minnesota and New Jersey have programs that are open to all homeowners without regard to age or physical disability, whereas twenty-five states limit their program to elderly and/or disabled. Moreover, the income limits in Minnesota and New Jersey are $60,000 and $100,000, respectively. Only one other state (Michigan) has an income limit higher than Minnesota, and no state exceeds the New Jersey limit. In short, unlike programs in Minnesota and New Jersey, most state property tax relief programs are targeted to population groups that are highly unlikely to itemize their deductions. These taxpayers will not be in a situation where the property tax rebate must be included in income and an information report will not be required for them to properly complete their tax return.

Nonetheless, a federal requirement to issue such information reports would impose significant costs on all states with property tax relief programs. A system would need to be designed, developed, tested and implemented even if only a relatively few reports were actually issued. In addition, each report issued would likely cost at least $1.00 per return for forms, envelopes, printing, postage and handling.

The Federation of Tax Administrators believes the objectives of the Congress (improved reporting of property tax rebates) can be substantially achieved through other steps short of mandated information reporting. The alternatives which could be pursued include:

- The Internal Revenue Service could clarify instructions to specify clearly that state-financed property tax rebates must be included in income to the extent they were deducted in the prior year.

- The IRS could work with states to report information to the Service on electronic media. This could include all states or a subset of states with programs serving taxpayers most likely itemize their deductions, e.g., universal programs with relatively high income thresholds.

- The IRS could work with states to include a notification to the taxpayer along with any rebate check that the rebate may need to be included in income if the taxpayer itemized his/her deductions in the prior year.

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[2] Maryland, which limits relief to households with less than $200,000 net worth, is counted among those with an income limit exceeding $30,000.

[3] About one half of the states provide relief to qualifying renters by treating a specified proportion of rent as property taxes.

[4] The other four states with income ceilings in excess of $30,000 paid a total of about $139 million in relief to homeowners. The 30 states with income ceilings below $30,000 paid about $515 million in relief to homeowners. Of this, $370 million was paid in five states – Illinois, Ohio, Pennsylvania, Washington and Wisconsin.

- The IRS could work with states to have those states which incorporate paying the property tax rebate as part of the income tax refund to include the amount of the refund in the 1099-G sent to the taxpayer with regard to his/her income tax refund.[5] This could improve coverage of information reports in about half of the states.
- The IRS could work with that relative handful of states that comprise the bulk of the payments for which there should be concern to develop means of addressing the issue on an individualized basis. Such an effort would be consistent with the Compliance 2000 approach of the Service.

In recent conversation with GAO representatives, the GAO has agreed with most of our points. In conversation IRS has also agreed that the GAO report overstated the value of such information reporting. We understand that GAO is no longer interested in pursuing any 1099-type information reporting for property tax rebates, but instead believes it may have developed a more administrable plan by working with the local governments, specifically the National Association of Counties, which convened a working group this summer to address the GAO's compliance concerns. We applaud these alternatives, and stand ready to work with GAO and the IRS on other approaches.

Finally, I would point out that Congress addressed a somewhat related issue in 1992. H.R. 5653 from the 102nd Congress (which was defeated by a House vote) and Section 3009 of the Senate version of H.R. 11 (later stripped by the conference committee) would have required any state and local government that "makes payments of refunds of ... real property taxes (or allows credits or offsets with respect to such taxes) aggregating $10 or more" or "receives payments of State and local real property taxes aggregating $10 or more" from individuals to file a 1099-report showing the amount of the refund, credit or offset as well as the name, address, and Taxpayer Identification Number of the individual. The government unit would have to send 1099 reports to the IRS and to those taxpayers who itemize deductions.

As we read the language at that time, it did not seem to cover state property tax rebate and Circuit Breaker programs because they were not "overpayments" in the sense that term was used in the relevant statute. Under IRS regulations for the income tax refund 1099s, credit or offset is defined as an "overpayment of liability" which, instead of being refunded, is used to offset other debts. Various IRS and Congressional staff members agreed with our interpretation.

However, for the reasons already stated, regardless of the extent of the requirement, the FTA does not believe that any 1099-type information reports will serve the federal purpose and they will place significant administrative burdens on the state and local tax authorities.

In conclusion, the Federation of Tax Administrators applauds efforts to improve compliance with the nation's tax laws. We believe, however, that mandatory information reporting for state-financed property tax rebates will do little to achieve that goal because of the nature of the rebate programs in most states. At the same time, any such a mandate will impose significant costs on a number of states at a most inopportune time. We believe also that the intent of the information reporting requirement can be accomplished through other means, as shown by the cooperative approach now being developed by the GAO and the National Association of Counties.

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[5] It is apparently the IRS policy that rebates paid as part of the income tax refund are not to be included in the 1099-G for income tax refunds. FTA discussions with the states indicates this policy is not followed in all states, i.e., some states include that portion of an income tax refund attributable to a property tax credit in the 1099-G.

STATE PROPERTY TAX RELIEF PROGRAMS

State	Coverage	Income Ceiling	Relief	Benefactors Homeowner:	Benefactors Renters	Total Benefits Homeowner	Total Benefits Renter
Arizona	65	5,500	a,b	25,033	0	$6,658,000	$0
Arkansas	62, b	15,000	b	33,381	0	3,950,555	0
California	62, a	24,000	b	31,000	151,000	2,600,000	13,700,000
Colorado	58, a, b	11,200	b	47,000	0	11,315,893	0
Connecticut	65, a, b	24,700	c	39,000	27,000	15,400,000	10,200,000
D.C.	65, a	20,000	a	26,902	0	8,854,000	0
Hawaii	universal	30,000	a	0	61,913	0	5,819,000
Idaho	65, a, b,	16,510	c	21,222	0	6,031,000	0
Illinois	65, a	14,000	b	113,191	226,086	98,597,512	0
Indiana	65	10,000	a	N/A	N/A	N/A	N/A
Iowa	65, a, b	14,000	b,c	26,267	18,326	6,744,340	5,698,330
Kansas	55, a	17,200	b	50,397	0	8,700,000	0
Maine	universal	50,000	b	77,344	0	18,825,452	4,089,732
Maryland	universal	0	b,c	76,670	12,226	45,000,000	3,397,000
Michigan	universal	82,650	a,b	1,535,800	0	773,555,000	0
Minnesota	universal	60,000	b	200,481	262,604	47,768,500	86,648,500
Missouri	65	15,000	a,b	68,600	0	17,973,000	0
Montana	62	0	a	12,970	4,324	3,068,748	1,022,917
Nevada	62	19,100	b	12,550	0	2,636,000	0
New Jersey	universal	100,000	b	851,000	788,000	245,000,000	73,000,000
New Mexico	65	16,000	b	22,637	4,251	3,346,000	546,000
New York	universal	18,000	a,b	102,599	441,074	12,862,000	37,937,000
North Dakota	65, a	13,000	a,b	7,029	1,582	2,230,636	151,600
Ohio	65, a, b	16,500	c	281,645	0	56,094,000	0
Oklahoma	65, a	10,000	a,b	3,387	0	398,000	0
Oregon	58	10,000	b	0	11,372	0	6,365,000
Pennsylvania	65, a, b	15,000	b	241,770	180,585	58,497,025	50,184,338
Rhode Island	65, a	12,500	a,b	3,836	0	653,000	0
South Dakota	65, a	12,000	b	7,007	0	1,000,000	0
Tennessee	65, a, b	9,200	b	78,342	0	7,026,000	0
Utah	65, b	17,325	a,b	16,900	900	3,900,000	0
Vermont	universal	45,000	a,b	28,880	13,581	18,000,000	4,500,000
Washington	61, a	26,000	c	105,000	0	52,000,000	0
West Virginia	65	5,000	b	26	0	0	0
Wisconsin	universal	19,154	a,b	248,249	0	105,505,000	0
Wyoming	65, a	14,000	b	9,181	0	0	0
	Avg. Ceiling:	$23,163		4,405,296	2,204,824	1,644,189,661	303,259,417

Coverage	Types of Relief
a) Physical disability	a) Income Tax Credit: 14
b) Marital status	b) State Rebate/Direct Payment: 28
	d) Credit Against Local Tax: 6

Source: Advisory Commission on Intergovernmental Relations, Significant Features of Fiscal Federalism, Vol. 1, 1993 and FTA phone survey March 1993. Data are gnerally for 1992 benefit year.

Coughlin & Gomola

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September 16, 1993

Janice Mays, Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, DC 20515

RE: Press Releases #9 & #10
Ways and Means Select Revenue Subcommittee

Dear Ms Mays:

I was very disheartened to read the above press releases, especially noting that #9 was issued seven days after President Clinton signed the Revenue Reconciliation Act of 1993.

As tax practitioners we have begun the process of digging through the Act just signed. We must understand the law for compliance and planning purposes, so we are spending many hours reading the text of the Act itself for the technical aspects, the Committee Reports to understand the Congressional intent, and the analysis prepared by national tax reporting services. We have made plans to attend seminars to hear national experts explain their understanding of the changes. We are spending many more hours talking on the phone and having conferences with our clients to explain how the new law affects them. We have already written and mailed a four page newsletter to our clients highlighting the key provisions. Now we find out that just seven days after the largest tax bill since 1986 has been signed, your committee is considering a host of additional measures and changes.

A few of these proposals directly change items already hotly debated and included in the Revenue Act, most notably changing the safe harbor estimated payment from the just passed 110% to 115%. How can you seriously consider changing that before the ink is even dry?

We practitioners, and our clients become extremely frustrated when the rules keep changing. The constant changes, and the retroactivity have made prudent planning nearly impossible.

The changes proposed in the above cited press releases are even worse because they are minor tinkering designed to raise hidden revenue. Additionally, the compliance aspects of these changes are costly to taxpayers because they will require businesses to keep additional records, alter existing systems, or (more likely) to reconstruct the information at tax time.

If more revenue is needed, after careful consideration of spending restraints, then please raise the actual rates. The increased revenue should be out in the open, and not disguised.

I cite these opinions not only as a tax practitioner, but as Past Chairman of the Middlesex County Chamber of Commerce.

Thank you for your time and understanding.

Sincerely,

Gary R. Gomola, CPA

GRG/jmh
cc: Honorable Barbara B. Kennelly
Honorable Nancy C. Johnson

STATEMENT OF THE
COALITION ON INTEREST DISALLOWANCE

Introduction

The following statement is presented by the Coalition on Interest Disallowance in response to an August 18, 1993, request by the Subcommittee for comments on a proposal to deny a corporate deduction for all or part of the interest paid to the Internal Revenue Service on tax underpayments. The Coalition appreciates this chance to provide its observations to the Subcommittee as the House Committee on Ways and Means considers various revenue-raising proposals to offset the cost of technical corrections, simplification, and other tax proposals that may be considered in the future.

Notwithstanding its substantial revenue-raising capabilities, denial of the corporate deduction for interest paid to the IRS on tax underpayments would be bad tax policy, for the following reasons:

- The proposal would be an unjustified departure from the concept of a net corporate income tax.
- It would penalize taxpayers who act in good faith.
- It would create a perception of unfairness that is damaging to the voluntary nature of our tax compliance system.
- The proposal would adversely affect tax administration.
- Although tempting to do so, this proposal should not be compared to the disallowance of deficiency interest for individuals.

As you are aware, this proposal appears to be the same as a suggestion raised as part of the 1990 Budget Summit Agreement. During the ensuing debate over that legislation, however, the proposal was eliminated because Congress and the Treasury Department agreed it did not reflect good tax policy. In its place, Congress enacted Code Section 6621(c), the so-called "hot interest" rule.

The proposal departs from the net income tax concept

Interest is the price paid for the use of someone else's money. The tax law has always allowed corporations a deduction for interest expense, including interest paid with respect to tax obligations. This deduction is an integral part of the concept of the net income tax. For corporations, interest expense is one of the costs of producing income, and the net income tax appropriately permits the deduction of interest prior to the computation of tax.

Departures from this concept of net income exist, but they are extremely limited. For example, public policy considerations have resulted in the denial of deductions for payments that constitute monetary civil or criminal penalties, certain damages under the antitrust laws, or bribes or kickbacks. In these limited situations, the overwhelming public policy to impose a penalty overrides the general rule that a taxpayer should be able to deduct all costs of producing income. No such policy considerations exist in the context of interest on tax obligations.

Congress also has chosen to limit certain other deductions, such as meals and entertainment expenses. Congress has noted, however, that this type of deduction is associated with expenses that have a personal element to them. This is to be contrasted to the deduction for interest paid on corporate underpayments, which has no personal component to it.

The proposal penalizes taxpayers who act in good faith

The income tax system has become so complex in recent years that it is now virtually impossible for any large corporate taxpayer to be certain how the tax law will apply to its facts. In many instances, a taxpayer's ultimate liability is determined only after (1) the completion of an examination, (2) resort to administrative appeals, and (3) a determination by a court. In addition to the law's inherent complexity, this problem is exacerbated due to delays in the issuance of guidance from the IRS and Treasury on complex issues raised by constantly changing statutory rules.

Eliminating the interest deduction for corporate underpayments would be nothing more than a new civil penalty on tax deficiencies. This new penalty would apply in a number of inappropriate situations. For example, the punitive treatment would apply in situations in which the IRS changed its position with respect to the treatment of an item. It also would apply in the case of retroactive changes that result from legislative, regulatory, or judicial action. In addition, this penalty would be aggravated by delays in the audit process, including delays attributable to the IRS.

If a taxpayer understates its liability, current law provides a number of civil penalties -- including the accuracy-related penalty -- that, if appropriate, may apply. This area of the law was subject to comprehensive review and reform in 1989, with the accuracy-related penalty recently being modified as part of the Omnibus Budget Reconciliation Act of 1993. To make interest nondeductible would simply create a new penalty for understatements that may already be subject to penalty.

Moreover, because of its "no-fault" nature, this new penalty would be assessed even if a taxpayer makes a good faith effort to comply with the tax law.

Unfairness of proposal would undermine voluntary compliance

Interest paid to a corporate taxpayer on an overpayment will continue to be includible in income. To deny a deduction for the similar interest paid by a corporate taxpayer adds to the impression that inconsistent rules are applied, depending upon which rule is more advantageous to the government. This impression undermines the fairness of the Federal tax system and damages the voluntary compliance ethic.

Additionally, denying the corporate deduction can "whipsaw" corporate taxpayers. Consider the following situation:

> Corporation X pays a proposed deficiency and incurs nondeductible interest. Corporation X then contests the IRS position by filing a claim for refund and wins in District Court. Corporation X would be subject to the "whipsaw" of nondeductible interest expense and includible interest income with respect to the same item.

The proposal creates serious administrative problems

The proposal would adversely affect the ability of taxpayers and the IRS to reach agreement on examination issues, overload the Claims Court and the District Courts, and increase the nonproductive paperwork burden on both taxpayers and the IRS.

During an examination, the IRS frequently requests an extension of the statute of limitations on assessment from a taxpayer so it has enough time to adequately review the return. If the interest deduction was eliminated, the incentive would be greatly reduced for a corporation to agree to an extension.

Instead of extending the statute, taxpayers could demand assessments, pay them, and then flood the Court of Claims and District Courts with refund claims. In addition, because the U.S. Tax Court does not hear refund claims, this proposal would have the unintended effect of greatly reducing the importance of the judicial forum with the most expertise concerning tax matters.

In order to avoid the adverse effect of this proposal, taxpayers will be forced to overpay tax with respect to current good faith disputes with the IRS. The burden of filing amended returns and claims for refund would fall on both taxpayers and the IRS.

Comparison with the treatment of deficiencies on individual returns is inappropriate

During the early debate on the 1990 budget proposals, some supporters of the interest disallowance provision argued that the nondeductibility of interest on tax deficiencies incurred by individuals was a suitable reason for applying similar treatment to interest on corporate tax deficiencies. The reason for denying these deductions to individuals does not exist for corporate taxpayers.

An individual who underpays tax is effectively borrowing money (the amount of the underpayment) from the government, and such amount could be used for personal purposes. As with other individual interest expenses, such as interest on a personal car loan, a deduction may not be appropriate.

A corporation that underpays its tax also in effect borrows money from the government, but uses those borrowings to produce taxable income. A deduction in that case is not only appropriate, but is also necessary to measure net income.

The Coalition on Interest Disallowance would be happy to provide written responses to any questions the Committee may have on this issue.

Coalition on Interest Disallowance

Baxter International, Inc.

Caterpillar, Inc.

Citicorp

Dresser Industries

Emerson Electric Co.

General Electric Co.

General Motors Corporation

GenCorp Inc.

Great Western Financial Corporation

Hallmark Cards, Inc.

Hewlett-Packard Company

IBM Corporation

Kellogg Company

Merck & Co., Inc.

Minnesota Mining and Manufacturing (3M)

Pillsbury

Sara Lee Corporation

United Technologies Corporation

TESTIMONY OF MR. DAVID BELDING, CHAIRMAN, NEVADA RESORT ASSOCIATION, IN OPPOSITION TO A PROPOSED INCREASE IN THE RATE OF WITHHOLDING ON CERTAIN GAMING WINNINGS

WAYS AND MEANS SUBCOMMITTEE ON SELECT REVENUE MEASURES
CONGRESSMAN CHARLES RANGEL, CHAIRMAN
SEPTEMBER 21, 1993

I wish to take this opportunity to record my opposition to a proposal suggested to this Committee recommending that the rate of tax withholding on certain gaming winnings be increased from 28-percent to 36-percent.

The rationale for tax withholding is based on the principal that taxes should be withheld at the time income is earned, up to the limit of likely tax liability. This is to ensure that the federal government actually receives the taxes due it, and that such taxes are received in a timely fashion. The proposal before the Committee does not meet this test. First, even existing withholding provisions do not ensure that taxes withheld from gaming winnings approximate the tax liability that the taxpayer may actually incur. Taxes are withheld against proceeds of a winning wager without consideration of other associated gaming losses. By the end of the tax year, the taxpayer may end up with little or no tax due on his or her gaming activities because of overall gaming losses. Further, even if the taxpayer should have net gaming winnings, it is very unlikely that the taxpayer would incur a tax obligation of anything near 36% as a result of his or her gaming winnings. According to Las Vegas Tourist Convention records, the typical person visiting a Nevada casino is between the ages of 35 and 50, married, and has an annual income of between $25,000 and $60,000. This average Hotel/Casino patron would have to have net gaming winnings equal to several times their non-gaming income to incur an income tax obligation of 36-percent. Less than 5-percent of those gambling in our casinos would fall in the 36-percent tax bracket.

The Administration and Congress recently reaffirmed that withholding should reflect as closely as possible the taxpayer's actual tax obligation. In the 1993 Budget Act, which establishes the new top income tax rate for individuals at 36-percent, withholding on bonuses received by employees is limited to only 28%, the rate at which taxes on gaming winnings are withheld under existing law. This is clear evidence that the Administration and Congress do not believe that it is necessary to set withholding rates at 36-percent on extraordinary income in order to ensure that there is sufficient tax withholding.

In short, the proposal to increase withholding on gaming winnings that has been suggested to this Subcommittee achieves nothing more than requiring that the taxpayers provide the federal government with an interest free loan, which the government refunds to them at a later date.

This proposal also creates an unjustified burden on the gaming industry. High rates of withholding from gaming winnings remove funds from circulation and reduce the amount of money bet by casino patrons. This, in turn, reduces casino activity and profits, and ultimately reduces federal and State tax revenues. The facts clearly indicate that, to reflect actual taxpayer obligations, the rate of withholding should be lowered on gaming winnings, not increased.

The negative impact of additional withholding on gaming winnings hits not only the Hotel/Casinos that make up my Association, but is particularly hard on the nation's parimutuel businesses. It is common knowledge that the racing industry has suffered financially in the last several years. We have seen tracks close and the prices paid for yearlings fall dramatically. The gross amount bet on racing over the last ten years has not even kept pace with inflation. There can be no justification for imposing an additional tax burden on the parimutuel industry at this time just to give arbitrary tax breaks to other industries.

Finally, the federal government has the means of insuring that gaming winnings are reported for tax purposes. Along with the current 28-percent withholding requirement, Treasury regulations also require that an Informational Reporting Form 1099 be completed and submitted to the Internal Revenue Service for gaming winnings paid out in excess of $600.

The Hotel/Casinos which make up the backbone of Nevada's economy will make a major contribution to efforts to reduce the nation's federal budget deficit through changes in the tax laws enacted as part of the 1993 Budget Reconciliation Act. Because of these new tax laws, they will not only pay higher corporate taxes, but the tourist industry, their economic mainstay, will suffer because of higher fuel taxes and the reduced value of tax deductions for business travel, meals and entertainment expenses. This will, in turn, reduce available funds to State and local governments that depend on revenues from gaming operations. The gaming industry and the people of Nevada accepted these changes because of the dire need to gain control of our federal deficit for the good of all Americans, and because the burden will be shared by all sectors of our economy. However, parochial raids on our primary industry cannot be justified.

These proposed tax increases on the gaming industry are neither fair, nor do they reflect sound tax policy. We urge the Subcommittee to reject them.

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STATEMENT OF DANIEL D. LEVENSON IN SUPPORT OF THE PROPOSAL TO REQUIRE TAXPAYERS TO FILE INFORMATION RETURNS IF THEY PURCHASE MORE THAN $600.00 OF FISH FROM ANY SELLER IN A CALENDAR YEAR FOR THE PURPOSE OF RESALE

I, Daniel D. Levenson, a tax attorney employed by Lourie & Cutler, P.C., in Boston, Massachusetts, have represented before the Internal Revenue Service in the last 15 years many people who perform various functions in the commercial seafood industry. During that period of time, I have witnessed first hand the abuses of the income tax laws and perhaps other regulatory requirements in that industry which have been caused by the undocumented sale of seafood for cash.

The substantial majority of fishing boat owners in the United States who market their product through the well-established commercial distribution channels obey the conservation guidelines regarding the size of the product which they keep, and pay all of their federal and state taxes. However, as in any business, there are those who violate the established norms of practice, thereby seeking to gain an advantage over honest businessmen.

One of the ways used to avoid both the tax and other requirements imposed on honest fishing boat operators is to sell their catch to unlicensed dealers who back their trucks up to a pier at night, unload the seafood, and pay cash to the captain of the boat. Usually the price paid per pound of product is slightly less than if sold through the established channels, the reason being that the cash is not reported as income by the recipients, meaning both the fishing boat owners and the crew members who share that cash.

I have been told by the Internal Revenue Service that the problem is not local to the New Bedford area but is endemic in fishing ports around the country. It does not matter whether a truck backs up to a pier at night or a warehouse ship off-loads from a fishing boat at sea, the result is the same. Substantial sums of income escape taxation because the persons who buy the seafood are not presently required to report on information returns the identity of the recipients of the cash and the amounts received.

Based on information provided by the Internal Revenue Service several years ago, the amount of unreported income by both boat owners and crew members nationwide from the sale of seafood was estimated to be $480 million, with the consequent unreported tax by both the boat owners and crew members. I believe that the enactment of the proposed new Code Section 6050 O will give the Internal Revenue Service the necessary tool to improve tax compliance in the fishing industry, with an estimated annual increase of income tax collected to be $120 million per year.

I have sponsored this remedial compliance legislation to raise revenue in order to offset the very minor revenue loss which may be incurred as a result of the passage of the proposed legislation which will amend Code Section 3121(b)(20) to resolve certain ambiguities in that statute and to mitigate the harsh effects of an Internal Revenue Service interpretation of that law.

Daniel D. Levenson
Daniel D. Levenson

Statement of
Robert A. Georgine
President
Building and Construction Trades Department, AFL-CIO

Before the Subcommittee on
Select Revenue Measures
Committee on Ways & Means
The Honorable Charles B. Rangel, Chair
United States House of Representatives

September 22, 1993

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to submit this statement on behalf of the Building and Construction Trades Department, AFL-CIO, which is a federation of 15 national and international building trades unions representing more than four million construction workers across the country.

The Building and Construction Trades Department strongly supports the proposal, set out as a Miscellaneous Issue in the Subcommittee's Press Release No. 10 (August 18, 1993), under which construction industry employers would be excluded from the coverage of Section 530 of the Revenue Act of 1978. Enactment of this proposal would be an important step in correcting the current rampant misclassification of construction workers as independent contractors. Without legislation of this type, honest construction contractors will continue to suffer unfair competition from those who are prepared to cheat, and construction workers and their families will continue to be denied protections and benefits to which they are legally entitled.

The Department believes that any legislation that is enacted must contain specific, verifiable standards to define when a construction worker is an employee, and those standards must then be applied across-the-board to all construction industry employers without regard to Section 530.

I.
Worker Misclassification Is Rampant in Construction Industry

It is beyond question that worker misclassification abuses are rampant in the construction industry. The House Committee on Government Operations has so concluded based on extensive testimony.[1] Legislatures in at least 6 states have recognized that misclassification is a particularly severe problem in the construction industry and have responded by enacting targeted legislation authorizing losing bidders on construction contracts to sue for damages if the winning bidders are found to have misclassified their workers.[2] Similar legislation is pending in at least 2 other states.[3]

Because construction contracts are awarded through competitive bidding, employers have powerful incentives to treat their workers as independent contractors rather than employees. A construction contractor that misclassifies its workers is able to reduce its labor costs, which account for roughly 50% of the cost of the average construction contract, by 25-40% or more, thereby achieving an almost insurmountable bidding advantage on construction contracts to the clear detriment of legitimate contractors.

These ill-gotten cost savings result because an employer that misclassifies its employees as independent contractors does not pay the employer's share of FICA and FUTA taxes. In addition, by treating its workers as independent contractors, such an employer is able to avoid the administrative costs associated with withholding and depositing the employer and employee portions of the FICA taxes, as well as income tax withholding.

Perhaps more significantly, a construction contractor that improperly treats its workers as independent contractors achieves tremendous competitive advantages by avoiding workers compensation premiums. Those premiums generally constitute a significant and increasing portion of total labor costs in the construction industry where the potential for serious injury is high. Depending on the specific location and job category, workers compensation premiums in the construction industry may be 60% or 70% of wages.

A construction contractor that misclassifies also avoids providing its workers and their families with the benefits afforded under pension and other employee plans. Employers generally are not required under the terms of their plans to provide pension and welfare benefits, including medical benefits, to nonemployees such as independent contractors.

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[1] Comm. on Gov't. Ops., Contractor Games: Misclassifying Employees as Independent Contractors, H. Rep. No. 1053, 102d Cong., 2d Sess. (Oct. 16, 1992) at p. 7 (the construction industry "appears to be the industry most widely affected" by misclassification.)

[2] See, e.g., Comm. on Gov't Ops., Exploiting Workers by Misclassifying Them as Independent Contractors, 1st Sess. (April 23, 1991) at p. 76.

[3] See id.

II.

Legislation Is Needed To Correct Construction Industry Abuses

Legitimate contractors who properly treat their workers as employees are being squeezed out of business by contractors who engage in misclassification abuses. Construction workers are being unfairly excluded from the unemployment and workers compensation protections to which they are entitled as well as being denied the protections of many federal labor laws. Taxpayers are being forced to pick up the tab for those contractors who fail to make their proper contributions to social security, unemployment insurance, and workers compensation funds.

Experience has made it abundantly clear that correction of these abuses in the construction industry requires specifically targeted legislation. Current law encourages unscrupulous contractors to play the audit lottery, in the expectation that if they are ever caught they can claim to have been confused by vague standards or can hide behind one of the Section 530 safe harbors. Unfortunately, this strategy has too often been successful, thereby encouraging increased noncompliance.

The predominant test today for distinguishing employees from independent contractors is the "common-law" test, which examines the degree to which the employer has the right to control and direct the individual performing the work, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is to be accomplished. In applying the common law definition, the IRS normally will examine 20 factors to determine whether sufficient control and direction exist in the particular case to establish an employer-employee relationship. See Rev. Rul. 87-41, 1987-1 C.B. 296, 298-300.

In order to curb what was perceived as overzealous reclassification of workers by IRS agents, Congress created an important exception to the common law test when it enacted Section 530 of the Revenue Act of 1978. Under Section 530, employers who treat their workers as independent contractors are provided "safe-harbors" precluding the IRS from reclassifying the workers as employees under certain circumstances. The Section 530 safe harbors apply where (1) the employer relies on judicial precedent or an IRS ruling; (2) the employer relies on a prior audit by the IRS which did not result in its workers being reclassified, even if the audit did not examine the employer's treatment of its workers as employees or independent contractors; or (3) the classification of such workers as independent contractors is a recognized industry practice. In addition, Section 530 precludes the IRS from issuing guidance on the proper treatment of workers as independent contractors or employees.

In November of 1990, the House Government Operations Committee issued a report entitled "Tax Administration Problems Involving Independent Contractors," House Report 101-979, 101st Cong., 2d Sess. (1990) (the "1990 Committee Report"), which estimated that the misclassification of workers under the federal tax laws results in annual revenue losses in the billions of dollars.[4] The 1990 Committee Report concluded that the current 20-factor common law test is extremely subjective and often inconsistently applied. In addition, the Section 530 prior audit safe harbor creates substantial inequities among similarly situated employers.

The Subcommittee on Employment and Housing of the House Committee on Government Operations held a hearing on the problem of worker misclassification in April of 1991, focusing in particular on the construction industry. Witnesses at the hearing, including representatives of labor and industry, testified that many construction contractors deliberately misclassify workers. Witnesses from the IRS stated that, while the IRS was concerned about deliberate misclassification and had increased its employment tax audits, the Section 530 safe harbors "hamstrung" tax administration in this area.

In July of 1991, the House Small Business Committee's Subcommittee on Exports, Tax Policy, and Special Problems held yet another hearing on the problem of worker misclassification. In addition to focusing on the problems created by the 20-factor common law test, the Subcommittee considered whether Congress should provide more specific rules for determining whether workers are independent contractors or employees.

On June 8, 1993, the Commerce, Consumer and Monetary Affairs Subcommittee of the House Committee on Government Operations, held another hearing on worker misclassification, which it described as a "Review of the Administration and Enforcement of Employment Taxes." Marshall Washburn, Compliance 2000 Executive for the IRS, testified that in one IRS district, the IRS focused on worker misclassification in the residential construction industry. In so doing, the IRS learned that employers in that industry misclassify some 64% of their workers as independent contractors and that in 20% of the cases, the employers fail even to file Forms 1099 for their workers. In another IRS district, the focus has been on general contractors. Mr. Washburn testified that these general contractors had one of the highest classification error rates.

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[4] The findings incorporated in the 1990 Committee Report were based in part on three Government Accounting Office ("GAO") studies that had been commissioned by the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Government Operations Committee, following that Subcommittee's hearings on the issue on May 16, 1989. See GAO Report, GAO/GGD 89-110, Tax Administration: Missing Independent Contractors' Information Returns Not Always Detected; GAO Report, GAO/GGD 89-63, Tax Administration: State and Local Compliance with IRS Information Reporting Requirements; GAO Report, GAO/GGD 89-107, Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers.

III.
A Legislative Solution Can Eliminate Most Abuses

The Building and Construction Trades Department supports attempts to provide greater certainty within the construction industry concerning the proper classification of workers. In this way, noncomplying contractors will find it more difficult to claim confusion as a defense if caught -- and thus it will be easier for IRS to impose penalties to deter abuses.

One possible approach would be to provide bright line objective standards for determining when a construction worker is an employee or an independent contractor. Such a solution could be implemented by amending Sections 3121(d); 3306(i); 3401(c); and 7701(a)(20) of the Internal Revenue Code (providing definitions of "employee" for employment tax purposes) to set out those specific circumstances in which a construction worker will be treated as an independent contractor, and requiring that in all other cases the worker must be treated as an employee, regardless of any provision of Section 530.

Under this approach, which the Building and Construction Trades Department believes has merit, an individual construction worker would be treated as an independent contractor only if he or she:

1. holds himself or herself out to the general public on a regular and consistent basis, through advertising or otherwise, as a provider of construction services;

2. has a significant investment in one or more of the following: (i) heavy machinery or tools (as opposed to hand tools), (ii) office space, or (iii) other construction materials or supplies;

3. is paid in a lump sum, in installments based on a price set at the beginning of a job, or on commission (rather than by the hour, day, week, month, or some other measure based on the amount of time worked rather than progress made on the job);

4. has the potential to realize a profit on a job and is exposed to the risk of suffering a net loss on the job (other than the risk of profit or loss ordinarily assumed by employees, such as the risk that the employer will be financially unable to pay);

5. is not obligated to render the services personally;

6. was not hired through a labor union hiring hall or dispatch system to perform the services; and

7. does not otherwise qualify as an employee under the usual common law test.

* * *

The Subcommittee is to be commended for taking up this vitally important legislation. Compelling considerations of fairness to legitimate contractors and to construction workers and their families, require that prompt action be taken.

Thank you, Mr. Chairman

TESTIMONY OF COALITION FOR INDEPENDENT CONTRACTORS

The Coalition For Independent Contractors (the "Coalition") consists of representatives of the American Pulpwood Association, Inc., the American Trucking Associations, the Direct Selling Association, the Independent Insurance Agents of America, the National Association of Casualty and Surety Agents, the National Association of Independent Insurers, the National Association of Professional Insurance Agents, the National Association of Realtors, and the Specialty Advertising Association International. Each industry represented by the Coalition works with both independent contractors and employees. The Coalition represents an amalgam of industries, each sharing the precept that a business should have the right to use the type of worker, independent contractor or employee, that its management believes will best accomplish the business's objective.

The Coalition represents businesses that collectively engage over 5,000,000 independent contractors, throughout the country.

For the reasons set forth below, the Coalition strongly opposes the proposal to repeal section 530 of the Revenue Act of 1978 ("section 530") with respect to the construction industry, and urges that before considering any legislative change, the Internal Revenue Service ("IRS") first undertake a program to enhance its administration of existing worker–classification laws with respect to the construction industry.

I. Background.

While the Coalition has historically been steadfast in its support for the right of any business to choose the type of worker to engage, the Coalition has, at the same time, been actively involved in educating taxpayers about their compliance obligations with respect to Federal employment taxes.

Indeed, each of the industries represented by the Coalition has taken action to promote proper compliance with Federal tax laws by both its members and the independent contractors whom its members engage. Many Coalition members sponsor ongoing programs that educate both businesses and independent contractors concerning their respective obligations under federal tax laws, as well as under other laws, such as labor and health laws.

The view is unanimous among Coalition members that independent contractor status is a legitimate alternative form of doing business, and is not a device to avoid taxes.

The Coalition opposes the proposal to repeal section 530 with respect to the construction industry because the provision's repeal would not address the specific misclassification problems affecting the industry, and would result in many businesses whose relationships with independent contractors are clearly appropriate losing their protection against the overzealous enforcement practices of the IRS.

II. Section 530 is not the cause of the worker misclassification problems that some contend exist within the construction industry.

If worker misclassification problems do exist within the construction industry, they are not caused by section 530. While some specific examples of misclassified workers were cited at a 1991 Congressional hearing concerning worker misclassification problems within the construction industry, the businesses involved in the examples cited would not qualify for protection under section 530.

For example, one witness at the hearing complained of instances where "a contractor hires day laborers, pays them cash, and neither the employer or the employee reports the transaction to any government body."[1] There is no question that section 530 does not protect the service recipient under such circumstances. The clear wording of section 530(a)(1)(B) denies section 530 protection to any business that does not file all required IRS information returns, such as Forms 1099, to report the amount of compensation paid a worker.

Another witness complained that the classification of workers as independent contractors by businesses in the construction industry is a relatively recent phenomenon, and that years ago it was common for construction workers to be treated as employees.[2] If this is true, then section 530 simply is not applicable to a large segment of the construction industry. Subsections 530(a)(1)(A) and (a)(3) unambiguously condition section 530 applicability on the business 1) having always treated the specific worker under review as an independent contractor, and 2) having treated any worker holding a position substantially similar to the worker under review as an independent contractor for any period beginning after December 31, 1977. Thus, section 530 will generally not afford a business any protection with respect to its classification of workers for Federal employment tax purposes if the business had ever treated such workers, or others holding substantially positions, as employees.

Complaints were also expressed of workers being engaged as independent contractors to work alongside others who are treated as employees, and who presumably are doing the same type of work.[3] Section 530(a)(3) specifically denies section 530 protection in cases where individuals holding substantially similar positions are treated differently for Federal employment tax purposes.

The testimony of one witness focused on "phony franchising" arrangements, pursuant to which a building service company sells individuals a "franchise" representing the right to clean a specific floor of an office building.[4] Again, there is no indication that the putative franchisors are relying on the protections of section 530 in carrying out these arrangements.

Finally, with respect to the complaint regarding a business treating workers as employees only for the first 40 hours of each week, and as independent contractors for additional hours worked,[5] a repeal of section 530 would not alter the current consequences, inasmuch as subsection 530(a)(1)(A) currently denies section 530 protection with respect to any worker who has ever been treated as an employee.

By analyzing the application of section 530 to the specific complaints against the construction industry, it becomes clear that section 530 is not the cause of the problems. And, this should come as no surprise, inasmuch as section 530 was carefully drafted to provide the legitimate users of independent contractors a shield against overzealous IRS enforcement actions, without at the same time enabling those engaged in an improper use of independent contractors to avoid IRS enforcement of the law. This careful balance was accomplished by imposing stringent criteria that a business must satisfy in order to be eligible for section 530.

The foregoing discussion attests to the efficacy of section 530's stringent eligibility criteria in precluding the use of the provision to protect improper users of independent contractors, and demonstrates that, indeed, section 530 does not apply to the types of illegitimate uses of independent contractors that were described at the April 1991 hearing.

It is noteworthy that only one group that testified at the hearing, that is, the Building Service Contractors Association International, contended that section 530 was somehow responsible for the worker misclassification problems within the industry. The witnesses representing that group advocated modifying section 530 based only on bald statements that the year 1978 marked the beginning of a trend toward increased use of independent contractors within the construction industry, and that the prior audit safe harbor "has proven to be a problem."[6] In addition, the witnesses contended that in some metropolitan areas, the use of independent contractors in the building services industry has become an "industry practice," and therefore urged that a national standard be imposed for determining whether the "industry practice" safe harbor of section 530 is satisfied.[7] It should be noted that even these witnesses complained of only certain aspects of section 530; they did not make a case for complete repeal of the provision.

III. The actual cause of the problems of worker misclassification within the construction industry is the inadequate enforcement of current law by the Internal Revenue Service, and state enforcement officials.

Many witnesses offered their own view of the causes of worker misclassifications within the construction industry. The almost unanimous theme of those views was that the problem is caused by something other than section 530.

One witness contended that the problem of worker misclassification in the construction industry is caused by "the subjective nature of the classification criteria."[8] This individual argued for a reform to the 20-factor common law test. Section 530 was not found to be the cause of worker misclassification problems that this witness encountered.

Another witness provided a list of seven specific recommendations for reform that he believed would be best suited for eradicating worker misclassifications within the construction industry. Conspicuously absent from this list was any proposal to repeal or otherwise modify section 530.[9]

One witness complained about the absence of effective government enforcement efforts. Specifically, the witness complained that "by the time a state or federal investigator arrives to investigate a complaint the offending contractor has moved on to another jobsite Moreover, many of the contractors who blatantly break the laws are from out of state with no ties to the community whatsoever."[10]

Another witness complained about the extreme difficulty encountered in motivating the IRS to take any action.[11] Surely, this witness would likely not take much solace in any legislative changes to substantive law. What this witness would like to see is a change in the way in which the law is enforced.

Apparently, the perspective of those "on the front lines" is that the misclassified independent contractors within the construction industry are a consequence not so much of failures in the law itself, but rather in the failures of the IRS and state officials to administer the law. In support of this proposition, a witness provided some interesting findings:

> An article appearing in Engineering News-Record, a prominent trade publication, reported: "According to a spokesman for the IRS regional office in San Francisco, they were able to recover $13.3 million in unpaid employment taxes in their nine-state region over a seven month period. More than half of the firms found cheating were construction related companies." (Engineering News-Record, June 22, 1989, p.10)[12]

The referenced article strongly corroborates the views expressed by many witnesses at the hearing that current law provides the IRS with adequate means to combat the problem of worker misclassification within the construction industry. Indeed, the course of action for addressing worker misclassification problems within the construction industry that the article calls for is a continuation of the IRS enforcement program that was the subject of the article, not a change in the law.

We understand that the IRS is currently working with construction industry groups, under the auspices of its Compliance 2000, in addressing the worker misclassification issue. We submit that this is the proper course to follow.

The specific problems cited at the hearing, coupled with the ideas offered for addressing such problems, all clearly point toward a need for better IRS enforcement of existing law. To respond to these circumstances by repealing section 530 would only harm the legitimate users of independent contractors, and fail to address the problems that the witnesses took their time to explain to the Congress.

IV. Conclusion.

It seems clear that if the construction industry actually is suffering from a significant universe of workers misclassified as independent contractors, the first response to be considered should be an enhanced IRS enforcement program that is directed specifically at worker misclassifications and focused specifically within the construction industry. Apparently, such a program has not yet been undertaken. Until current law is properly enforced, its efficacy in addressing the problems cited will never be known.

A leap to legislative change at this juncture would be based on unknown facts and unfounded speculations. Such an approach would only exacerbate the existing industry problems, by missing the illegitimate users of independent contractors, and rendering the legitimate users of independent contractors more vulnerable to IRS attack. As demonstrated above, section 530 accords improper users of independent contractors no protection. Such taxpayers rely not on any specific law, but rather on the belief that the IRS will never catch them. Unfortunately, the taxpayers that would be affected most by repealing section 530 are those construction businesses that use independent contractors in legitimate arrangements. These taxpayers, the intended beneficiaries of section 530, would lose their protection against IRS abusive enforcement tactics.

So long as the IRS is perceived as neglecting to enforce the law, any tinkering with the law itself will not produce results. If a law is not enforced, the specific provisions of that law are of no significance.

For the foregoing reasons, the Coalition strongly urges that the Congress not consider any legislative change to address the worker misclassification problems that might exist within the construction industry. Rather, we urge that the Congress first encourage the IRS to undertake a program to better enforce current laws in this area as they apply to the industry.

Respectfully submitted,

The Coalition For Independent Contractors

[1] Testimony of Wayne Pierce, General Treasurer and Director of Political and Legislative Affairs, United Brotherhood of Carpenters and Joiners of America, Before the Subcommittee on Employment and Housing, Committee on Government Operations, U.S. House of Representatives, on April 23, 1991.

[2] Testimony of John W. Cunningham before the Subcommittee on Employment and Housing, Committee on Government Operations, U.S. House of Representatives, on April 23, 1991.

[3] Testimony Before the Employment and Housing Subcommittee On Tuesday, April 23, 1991 by Michael J. Sullivan, on behalf of the Sheet Metal Workers' Local Union Number 20.

[4] Testimony of Tom Balanoff, Building Service Division Director, Service Employees International Union, AFL-CIO, CLC, Before Subcommittee on Employment and Housing Government Operations Committee, U.S. House of Representatives, April 23, 1991.

[5] Testimony Before the Employment and Housing Subcommittee On Tuesday, April 23, 1991 by Michael J. Sullivan, on behalf of the Sheet Metal Workers' Local Union Number 20.

[6] Public Testimony on Misclassification of Employees as Independent Contractors Before the Employment and Housing Subcommittee of the Committee on Government Operations U.S. House of Representatives, April 23, 1991, Presented by Mr. Richard L. Thompson, Mr. Alan Diamond, Building Service Contractors Association International.

[7] Public Testimony on Misclassification of Employees as Independent Contractors Before the Employment and Housing Subcommittee of the Committee on Government Operations U.S. House of Representatives, April 23, 1991, Presented by Mr. Richard L. Thompson, Mr. Alan Diamond, Building Service Contractors Association International.

[8] Testimony of Wayne Pierce, General Treasurer and Director of Political and Legislative Affairs, United Brotherhood of Carpenters and Joiners of America, Before the Subcommittee on Employment and Housing, Committee on Government Operations, U.S. House of Representatives, on April 23, 1991.

[9] Testimony of Michael D. Hobbs, a trustee of the Carpentry Industry Partnership, before the House Government Operations Subcommittee on Housing and Employment, April 23, 1991

[10] Testimony of Michael D. Hobbs, a trustee of the Carpentry Industry Partnership, before the House Government Operations Subcommittee on Housing and Employment, April 23, 1991

[11] Testimony Before the Employment and Housing Subcommittee On Tuesday, April 23, 1991 by Michael J. Sullivan, on behalf of the Sheet Metal Workers' Local Union Number 20.

[12] Testimony of Michael D. Hobbs, a trustee of the Carpentry Industry Partnership, before the House Government Operations Subcommittee on Housing and Employment, April 23, 1991

Hearing on Miscellaneous Revenue-Raising Proposals
Subcommittee on Select Revenue Measures
Committee of Ways and Means

Statement for the Committee Hearing Record by
Myron Hulen, PhD, Colorado State University, Fort Collins
William Kenny, JD, CPA, Portland State University
Jack Robison, PhD, CPA, California Polytechnic State University, San Luis Obispo
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Submitters' Background

The authors have been researching Section 530 and other issues affecting the compliance levels and classification of independent contractors in connection with the preparation of a "white paper" for the American Tax Policy Institute. The views expressed are the authors' and do not necessarily represent the views of the American Tax Policy Institute.

HOW SECTION 530 MIGHT BE STRENGTHENED AND CLARIFIED

Why should a provision that was intended to be temporary be retained? The principal reason is that the situation has not changed significantly since it was enacted: the 20 factor test has not been clarified, and the IRS has again increased its enforcement of employment tax laws.[1]

Clarification of the Reasonable Basis Standard

Section 530 specifies three statutory methods of fulfilling the reasonable basis standard. "A taxpayer who fails to meet any of the three safe havens may nevertheless demonstrate, in some other manner, a reasonable basis for not treating the individual as an employee."[2] The standard which provides for reliance on judicial precedent, published rulings, etc., appears to require no modification. The other standards are discussed below.

What Constitutes a Prior Audit? This area has caused the most controversy and the GAO reports that it was found to be the most frequently applicable reason for the protection of Section 530 to apply.[3] An audit need not deal with employment issues to meet the safe harbor, and once obtained its protection is perpetual. The safe harbor therefore provides potential competitive advantages.[4]

The AICPA proposes that prior audits only be considered when the facts are substantially the same and the previous audit documents that the worker status issue was raised.[5] H.R. 5011 and the drafter of H.R. 4216 would go further and limit application of the prior audit rule to employment tax audits.[6] The rationale for these changes is that the safe harbor provided by Section 530 should not apply when the classification issue was not raised during the audit.

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[1] In fact in the IRS's current budget proposal it is the Service's most costly initiative. The IRS is "seeking to add 397 full-time equivalent positions and about $31.6 million to ensure proper employee classification" ("Budget Outlines IRS Enforcement Spending," Tax Notes (April 19, 1993), p. 316).

[2] Rev. Rul. 83-152, 1983-2 C.B. 172, clarifying the meaning of Section 530(a)(1)(B). The committee report on Section 530 also supports this broad interpretation of reasonable basis (H.R. Report 95-1748, p. 631, 633) and at least one court case has dealt with the issue (American Institute of Family Relations, 79-1 USTC 86,877 (D.C. Central Dist. CA, 1979)).

[3] GAO/GGD-89-107, p. 8.

[4] 36th Report CGO, p. 13.

These proposals have been criticized because many income tax audits "examine" independent contractor agreements without formally opening an employment tax audit. In other situations "current 'employment compliance' audits are open ended--that is to say, you are specifically told that you will not receive any notice if satisfactory compliance is found--the audits are truly never 'closed.'"[7] Such tactics might be likely to increase if a specific type of audit was required.[8]

The requirement that the prior audit rule be restricted to employment tax audits of some specific variety would complicate the law and greatly limit the applicability of Section 530. The Committee on Government Operations and the Section of Taxation of the ABA propose that the rule be left as is (any type of audit) but that prospective reclassification be allowed if the taxpayer has no basis other than a prior audit for treating workers as independent contractors.[9] The Small Business Administration notes that the IRS now trains new revenue agents to inquire about the possible existence of misclassified workers.[10] It can therefore be argued that blatant misclassifications are unlikely to escape detection during most audits.

Recommendation. Retain the prior audit rule in its current form. This is recommended because the IRS would be allowed to reclassify workers prospectively and IRS rulings will be permitted to terminate its protection (these recommendations will be explained later). If the misclassification is not blatant enough to attract attention on an audit and all necessary information returns have been filed, then the penalties and trauma of retroactive reclassification is not warranted.

What Constitutes a Substantially Similar Position? The requirement that a worker be treated the same as individuals holding positions which are substantially similar is contained in both the prior audit and the consistency requirements.[11] This terminology can be interpreted to refer to the need for workers to perform similar job duties or alternatively to have a similar relationship (type and level of control) with the firm. In Rev. Rul. 87-41 the IRS stated that the outcome depends on all the facts and circumstances, including particularly the activities and functions performed by the individuals.[12] The Court of Appeals for the Fifth Circuit ruled that working in different industries (type of work) was of less importance than the structure of the relationship between the taxpayer and his workers.[13] The IRS' continued pursuit of cases involving this issue and the inclusion of similar language in proposed legislation such as H.R. 5011 reveal the need for clarification.

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[5] Hearing Record of Select Revenue Measures Subcommittee, p. 134.

[6] In his testimony, however, Representative Barnard states that protection would apply when a specific employment tax audit finding on classification is reduced to writing. This is a position more similar to the AICPA's. Hearing Record of Select Revenue Measures Subcommittee, p. 20 and 34.

[7] "Congressional Testimony on Independent Contractors," CCH Payroll Management Guide, 6/22/93, p. 6422.

[8] The incentives for such tactics are decreased when Section 530 protection is not permanent.

[9] 36th Report CGO, p. 13; Hearing Record of Select Revenue Measures Subcommittee, p. 126. It should be noted that the Section on Taxation's views have not been approved by the ABA.

[10] SBA, Hearing before SB Subcommittee, p. 13.

[11] Section 530(a)(2) and (3).

Recommendation. Clarify the definition of substantially similar so that it applies when workers have a similar relationship with the firm. The structure of the relationship rather than the particular job duties performed should be the determining factor. That is, it is the level of firm control over the worker that should determine classification rather than the particular duties that a worker performs.

What is Required to Prove a Long-Standing Recognized Practice of a Significant Segment of the Industry Exists? Clarification is needed concerning the meaning of three separate terms: long-standing, significant, and industry. The level of proof required has also been an issue.

The long-standing requirement causes difficulties when new industries emerge due to technical and other innovations. The question arises if they must wait some period of years before the provisions of Section 530(a)(2)(C) can apply.

The only clarification as to when a practice is considered significant is in the explanation of Section 530 which states that the test does "not require that a practice be uniform."[14] In other sections of the Code the meaning of significant varies widely.[15] One industry representative states that "many IRS auditors will not recognize a practice as "significant unless more than 50% ... follow the same practice," and argues that 20 percent is the appropriate level. A clearer definition of "significant" is plainly called for.

The term industry was the controversy in the General Investment Corp. case. There the IRS argued that the nationwide practice for an industry should be used for this purpose or, at the minimum, the nationwide practice of firms of a similar size. The court held that would thwart congressional intent and allowed the company to show that the practice was substantial in the county in which they operated.[16] The IRS Manual now states that evidence needs to be presented for the "locality (the locality must be specified, such as city of. . .)."[17] It is unclear whether a nationwide showing or something in between that and a city now will be allowed.

Finally the type of proof that must be presented to meet the industry standard is unclear. In General Investment Corp. the evidence was provided by the firm's president and one other business operator. They also testified as to the operations of others based on visits to those other businesses. This was considered adequate proof.[18] Conflicts also arise concerning whether survey results that fail to identify the respondents by company name can be used. Clarification is necessary as to what questions must be asked and what protocol is necessary to protect the survey's integrity.[19]

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[12] 1987-1 C.B. 296.

[13] Lambert's Nursery and Landscaping, Inc., 894 F.2d 154 (5th Cir. 1990). Also see the NACCB Statement for an excellent discussion of this issue. Hearing Record of Select Revenue Measures Subcommittee, pp. 269-70.

[14] 1978-3 C.B. 631, 633.

[15] For example: 50 percent in Treas. Reg. Sec. 1.6661-3(a)(2) and 10 percent for I.R.C. Sec. 6662(d)(1)(A)(i).

[16] 823 F.2d 337 (9th Cir. 1987) at 340.

[17] IRM - Administration, 5(10)26.4(1)(c)1.b.

[18] 823 F.2d 337 (9th Cir. 1987).

Recommendations. Clarify the definition of the following terms:

1. Long-standing should not be taken to exclude newly emerging industries.
2. A practice should be considered significant if it occurs in over 25 percent of the industry.
3. The taxpayer is to be given latitude in determining what they consider to be the relevant industry. Relevant comparisons could range from firms in the same city to firms in the nation.
4. All types of evidence should be considered as proof: surveys, letters from firms and/or oral statements. The IRS should be instructed to provide guidance as to appropriate standards for industry surveys.

The above clarifications are based on Congress' stated intention to construe Section 530 liberally in favor of the taxpayer.[20] Any revisions to Section 530 should reiterate that statement so that Congressional intent remains clear.

Section 530 Applies to Only a Limited Group for a Specific Purpose

The Section 1706 Limitation. Section 1706[21] eliminates Section 530 protection for three party situations in the technical services industry. Three party employment practices involve the use of a broker to locate consulting opportunities for the technical worker. It was originally enacted because it was claimed that this type of worker had a lower rate of compliance than other workers.[22]

The provision has presented few administrative problems other than the need to clarify what occupations it covers. A recent Treasury Department study concluded that the reporting of covered workers is at least as good as, and perhaps superior to, reporting by other misclassified workers.[23]

Recommendation. Repeal the Section 1706 limitation. There is no justification to support the exclusion of three party technical service workers. Their exclusion merely serves to complicate the law.

The Section 530 Safe Harbor Only Applies for Employment Tax Purposes and is Not Part of the IRC. There are two reasons for incorporating Section 530 into the Code: (1) to put it where it can be easily found, and (2) to extend its provisions to the classification of workers for purposes other than employment tax. The wisdom of including Section 530 within the IRC is obvious and probably was not done because it was meant to be temporary.

Under the current limitations of Section 530 it is possible for a worker to be classified as an independent contractor for employment tax purposes and as an employee for income tax and benefit plan purposes. The AICPA expresses the need best in stating:

"the conflicting definitions in these areas (employer-

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[19] SBLC, Hearing before SB Subcommittee, p. 8.

[20] HR Report 95-1748, p. 633.

[21] Section 1706 of the Tax Reform Act of 1988 added subsection d to Section 530. Section 530 is reproduced in Appendix B.

[22] Congressional Record, 6/20/86, S8089.

[23] Section 1706 Report, p. 55.

> employee, payroll, fringe benefit and retirement concerns) present a mine field waiting to explode on the small business person who must make employment decisions. As a result, we recommend uniformity regarding definitions of an employee in the fringe benefit and qualified retirement plan areas ... "[24]

H.R 5011 extends the application of Section 530 to all areas of the Code, and H.R. 4216 goes further and extends the definition to states for unemployment tax purposes.

Recommendation. Modify Section 530 and make it applicable for all tax purposes. There is no justification for worker classification to be determined differently for payroll, fringe benefit and retirement purposes.

Once Section 530 Protection is Obtained Both the IRS and the Taxpayer are Locked In

IRS's Inability to Reclassify Workers Protected by Section 530. The inability of the IRS to pursue reclassification for workers protected by Section 530 resulted in a loss of revenue of approximately $6.7 million for 1986 and 1987. Most of this revenue loss was estimated to be due to the prior audit protection.[25] There is general agreement that a change needs to be made to the prior audit standard if no reclassifications are to be allowed. There has been little discussion, however, of whether reclassification should be allowed when protection is based on one of the other reasonable basis standards. One alternative would be to apply the same standard to all areas. The alternatives that have been proposed are:

1. Allow retroactive reclassification in all circumstances.
2. Allow retroactive reclassification only if there was no basis other than a past income tax audit[26] or if no information returns were filed.[27]
3. Limit reclassification to the future if:
    a. the prior audit was an employment tax audit[28] or
    b. they acted in good faith, filed all necessary employment tax returns, did not treat others in a substantially similar position differently, agree to treat the workers as employees in the future, and file all necessary employment tax returns[29] or
    c. there was a past audit and all necessary information returns were filed[30] or
    d. all information returns were filed and there was no fraud[31] or
    e. in all situations due to the ambiguity of the 20 factor test.

A further consideration is whether the burden of proof should change in reclassification cases. This might be appropriate because the IRS is known to have a long-standing preference for employee designations[32] which results in bias when combined with the subjectivity of the 20 factor test. That is, if the examination starts from the viewpoint of "can the worker be considered an employee?" the result is likely to be different than if it started from the employer's view which is likely to be "can the worker be an independent contractor?"[33]

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[24] Hearing Record of Select Revenue Measures Subcommittee, p. 134-5.

[25] GAO/GGD-89-107, p. 8.

[26] ABA, Hearing Record of Select Revenue Measures Subcommittee, p. 126.

[27] 36th Report COG, p. 13.

[28] H.R. 5011.

[29] H.R. 4216.

[30] 36th Report CGO, p. 14.

[31] ABA, Hearing Record of Select Revenue Measures Subcommittee, p. 134.

Recommendations. Allow the IRS to reclassify workers protected by Section 530 prospectively using the time schedule proposed in H.R 5011. The burden of proof would be on the IRS to show that the prior classification was incorrect.

The common law rules are very subjective in nature. Reclassification should therefore not take place because in the IRS' view the scales tip slightly in favor of employee classification. The benefit of any doubt should be in favor of the original classification by the firm.

One of the criticisms of the existing provision is that even when the classification can be proven incorrect nothing can be done. This will not be the case under our proposals. Retroactive classification was not felt to be necessary or appropriate given the proposed compliance rules.

Firms are Reluctant to Change Worker Classifications Once Established. Where Section 530 protection is available, changes violate the consistent treatment rule and remove past Section 530 protection. The intent of the consistency provision was to prevent firms from changing workers from employee to independent contractor status to take advantage of the provisions of Section 530.[34] The Section of Taxation of the ABA recommends that the rule be revised to permit a change from independent contractor to employee status.[35]

Even firms without Section 530 protection are reluctant to reclassify workers because such a reclassification could be construed as an admission of past misclassification upon audit.

Recommendations. Amend the consistency rule to clarify that it applies only to changes from employee to independent contractor status. Firms should not be discouraged from reclassifying workers to employee status. The failure to allow such changes appears to be due to the failure to envision such a situation rather than congressional intent.

Establish an amnesty program for firms not covered by the Section 530 safe harbors. If all required information returns were correctly filed, the prior classification was based on a good faith misinterpretation of the common law rules, and the reclassification takes place prior to the receipt of any audit notification, then no penalties or payroll taxes should be imposed based on the past misclassification.

This provision is very similar to that proposed by H.R. 5011. Employers should be encouraged to change worker classification when the status was erroneously determined. This is in keeping with the IRS preference for employee status for administrative and other reasons. The amnesty should be well publicized and apply for one year after enactment.

The lack of clarity of the common law classification rules warrants the provision of amnesty for a limited period of time. We feel the situation differs from the compliance area where we recommended against amnesty, in that those rules are clear and thus amnesty would provide a benefit to firms who were merely not informed about the rules or chose not to follow them.

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[32] 36th Report CGO, p. 3.

[33] GAO/GGD-77-88, p. 11.

[34] HR Report 95-1748, p. 634.

[35] Hearing Record of Select Revenue Measures Subcommittee, p. 130.

Need for Additional Guidance

The Section 530 prohibition against IRS guidance was only meant to apply temporarily to provide Congress with time to resolve the issues in the area.[36] This was never done and Section 530 was first extended and then made permanent.

The result is that "taxpayers are frequently informed of IRS' interpretation of the rules in an ex post facto audit ... They cannot adjust their practices to reflect IRS' position before the audit because IRS interpretations are not published."[37] IRS agents also do not have any uniform interpretations to follow in auditing businesses and they are therefore free to do whatever they want.[38]

There is general agreement that the prohibition against guidance no longer serves any useful purpose and both H.R. 4216 and 5011 revoke it. There is however some concern about allowing the IRS rule as they choose. The Small Business Administration notes that the IRS has a vested interest in redefining the relationship between independent contractors and employees, stemming partly from the IRS' effort to alleviate administrative and compliance burdens.[39] Representative Lantos feels the Subcommittee on Select Revenue Measures should maintain oversight to insure that the rulings will be reasonable and helpful to all parties.[40]

Recommendations. Delete the prohibition against IRS guidance from Section 530. Guidance is needed by both taxpayers and IRS employees. Our recommended amendments to Section 530 clarify the classification rules and therefore remove the justification for suspending the IRS' ability to rule.

Also, taxpayers should lose Section 530 safe harbor protection if they take a position contrary to a published Revenue Ruling. Removal of Section 530 protection is recommended because, under guidelines proposed above, Section 530 protection should not be allowed to continue when a worker's classification is determined to be incorrect. Taxpayers in situations covered by a Revenue Ruling could reclassify the workers without losing past Section 530 protection as discussed earlier.

A NEW SAFE HAVEN: ESTABLISHING AN IMPROVED DEFINITION OF "INDEPENDENT CONTRACTOR"

The current safe harbors under Section 530 do not attempt to clarify the 20-factor test but instead merely offer shelter to employers who meet specific requirements: those previously audited, those following industry practice in hiring independent contractors; or those with judicial or administrative precedent. We recommend that a new Section 530 safe haven be added that is based on a clearly-defined subset of the current common law rules and that can be easily understood by taxpayers. Employers who do not meet this new standard or existing Section 530 safe harbor requirements would rely on the existing common law rules.

The need for simplified classification standards has been acknowledged for some time, and several agencies made suggestions in this regard. The failure of these simplified standards to be adopted in the past seems to have stemmed from a fear that they would result in a migration of workers to independent contractor status, resulting in a lower compliance rate. We reviewed the past proposals and evaluated them on their ability to provide results consistent with current IRS classifications; their availability to a reasonably large cross-section of the independent contractor population; and the migration to independent contractor status that might be expected from their use.[41]

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[36] HR Report 95-1748, p. 632.

[37] CGO, Hearing Record of Select Revenue Measures Subcommittee, p. 19.

[38] 36th Report CGO, p. 14; and ABA, Hearing Record of Select Revenue Measures Subcommittee, p. 127.

[39] SBA, Hearing before SB Subcommittee, p. 14.

[40] Hearing Record of Select Revenue Measures Subcommittee, p. 34.

Our major contribution in this regard was the ability to do this in an objective fashion through the use of a data base of facts and final classification results obtained from 321 IRS determination letters. We determined whether the model's requirements had been met for each ruling and then constructed a classification table that compares the IRS determinations with the results obtained with each of the proposed safe haven models.

We found that most of the model drafters were so concerned with migration of workers into the safe haven provisions that they made the model requirements too strict. When the requirements were relaxed--that is, fewer requirements were imposed for independent contractor classification--a number of the models provided results that were very consistent with IRS determinations.

Our recommendation for a safe haven is actually a combination of several of the models. Workers would be excluded from the common law definition of "employee" if they met at least one of the following four tests:

1. Can suffer a loss or make a profit
2. Have a principal place of business other than the service-recipient's
3. Generally make services available to the public as self-employed individuals
4. Work as an independent contractor for three or more service-recipients on a non-exclusive basis during the current or previous year

In addition, several compliance-oriented requirements would also have to be met-- such as the maintenance of books and records; the existence of a written agreement; and attestation that they are aware of their obligations and rights.

This model classifies 93 percent of the workers in a manner consistent with IRS determinations, and each of its tests is felt to require that the substance of the firm/worker relationship be consistent with independent contractor classification. Further, by being incorporated into Section 530, the IRS would be allowed to prospectively reclassify workers who qualify for the safe haven, should they be able to show that independent contractor status is incorrect.

The model that we have proposed is not felt to be uniquely superior and we would support other models that provide protection for a significant number of independent contractors. We are more concerned that a reasonable safe haven test be provided than we are that the specific model we advocate be enacted.

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[41] We reviewed simplified classification rules proposed by the Government Accounting Office, Small Business Administration, American Institute of Certified Public Accountants, National Federation of Independent Business, and several academic researchers.

SUBMITTED STATEMENT OF

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Subject: Independent Contractors and Small Business Growth Proposals

Before: House Ways and Means Committee

Date: September 21, 1993

Mr. Chairman, thank you for permitting the National Federation of Independent Business (NFIB) to express its views before this committee. NFIB would like to focus on two issues of importance to small business owners. First, this testimony will explore the issue of independent contractors. Then it will list a number of changes NFIB proposes be made to the tax code to encourage small business growth and development.

NFIB is the nation's largest small business advocacy organization, and our members are very concerned about tax issues. In fact, a recent survey found that five out of the top ten issues that concern small business owners the most are tax-related.[1] NFIB represents over 600,000 small business owners nationwide. NFIB members come from every industry and the typical NFIB member employs five to eight people. NFIB is currently celebrating its 50th year representing small business.

Small businesses are dramatically affected by the tax code, and our nation's economy is dramatically affected by small business. Since the early 1970's, small businesses have created about two-thirds of all net new jobs, the greatest number of these new jobs coming from businesses with fewer than 20 employees.[2]

INDEPENDENT CONTRACTORS

NFIB is concerned about efforts to limit the use of independent contractors for two reasons. First, many small business owners use independent contractors as an integral part of their work force and rely on independent contractors to give their business added flexibility. Flexibility is the one major advantage small business owners have over their larger competitors. Small businesses can change and adapt much faster than the Fortune 500, and as a result, these smaller businesses can take advantage of market niches that are not available to much larger firms. This flexibility, however, comes at a price. Small business owners cannot sustain significant downturns in their business. Unlike their larger counterparts, small business owners cannot just post a loss and keep on moving. They have no reserves and no line of investors waiting to help them through lean years. In order to stay in business, the owners of small firms must be able to react to changing market conditions and remain profitable.

Independent contractors are an essential element in the ability of small firms to react quickly to a changing economy. Independent contractors allow small firms to hire a worker with technical expertise that would otherwise be unavailable to the business. Independent contractors allow businesses to expand and contract on a project by project basis. Finally, independent contractors allow owners of cyclical businesses to maximize their output without having to lay off employees when the business cycle turns downward. In short, independent contractors allow small business owners to maximize the productivity of their businesses.

NFIB's second concern about attempts to limit the ability of workers to be independent contractors involves the restraint such limits place on the ability of workers to start their own businesses. Independent contractors are the smallest businesses, and Congress should be encouraging their creation. Many workers prefer to be their own bosses. They want to work their own schedules and at their own pace. Independent contractor status affords these workers that freedom. It allows them to pick and choose where and when they work. In an era of telecommuting and an increased focus on allowing workers to spend more time at home with their families, it is odd that some are exploring ways to close these avenues to workers.

NFIB encourages this committee to develop a simple, workable definition of an independent contractor. This simple definition should be crafted to allow business owners to quickly determine the status of their workers and to have that determination backed by a high degree of certainty. In addition, the definition should be liberal enough to take into account the wide variety of independent contractors who are currently serving the marketplace.

ENCOURAGING SMALL BUSINESS GROWTH AND DEVELOPMENT

> "... What most astonished me in the United States is not so much the marvelous grandeur of some undertakings as the innumerable multitude of small ones."
>
> **Alexis de Tocqueville**
> Democracy in America, 1840

Even as early as 1840 a foreign observer could conclude that much of America's success was a result of its entrepreneurial spirit. Yet a number of barriers have been erected for those who wish to begin a small undertaking. Entrepreneurs interested in starting a business today face a wide variety of hurdles. A number of these hurdles involve problems that are outside the jurisdiction of this committee, but many of them involve problems that can be solved through the tax code.

Entrepreneurs face three major hurdles that can be improved through amendments to the tax code:

* the financial and time commitments involved in starting a business;
* the financial problems involved in growing a business and its work force; and
* the financial problems involved in selling a business to start a new one.

Encouraging New Business Formation

Starting a business is expensive. However, a number of incentives could be added to the tax code to make it less expensive and to encourage potential business owners to go ahead and start their own firms. NFIB recommends that the following changes be made to the tax code:

Increase Expensing

The Omnibus Budget Reconciliation Act of 1993 helped small business owners by increasing section 179 expensing from $10,000 to $17,500. Unfortunately, this falls short of the $25,000 that we have determined is needed after many surveys of our 600,000 members about new business formation.

Expensing benefits small business owners in two ways. Expensing allows business owners to deduct the cost of new equipment in the same year the equipment is purchased, easing cash flow burdens on the business. In addition, expensing allows small business owners to avoid the complicated horrors of the depreciation tables. Instead of having to depreciate the cost of new equipment over a number of years, expensing allows business owners to deduct those costs when they are incurred.

Create a Targeted Investment Tax Credit

A significant barrier to business growth and development is having the money on hand to purchase the equipment needed to make the business fully productive. Small business owners listed "cash flow" as the third most important problem facing small business.[3] An investment tax credit targeted to small business owners will make these investments more affordable. At the same time, a targeted credit will focus this assistance on the segment of the business community most likely to respond with more jobs -- the small business community.

Allow Small Businesses to use Cash Accounting

Most small business owners are not accountants and many cannot even afford professional accounting advice. In fact only 32% of new small business owners have a college degree.[4] Yet the tax code forces many of these business owners to use the complex accrual method of accounting. This method of accounting adds to the already large paperwork burden on small businesses. 59% of small business owners already spend more than 10% of their time on record keeping.[5] Not only is the accrual method of accounting relatively complicated, but it also has the disadvantage of denying business owners a deduction for some of their inventory expenses. The accrual method of accounting allows business owners to deduct the cost of inventory only when it is sold. As a result, business owners must pay tax on the value of any inventory left at the end of the year.

NFIB suggests that this be changed and that small business owners with less than $5 million in sales should be allowed to use the cash method of accounting. Whatever small amount of revenue is lost by this change will be more than made up in added sales and tax revenue to the government by saving small business owners the hundreds of hours they spend trying to figure out the current system.

Exempt Small Business Owners from the Alternative Minimum Tax

The alternative minimum tax (AMT) is another complicated provision of the tax code that causes small business owners more trouble than it is worth to the federal treasury. The AMT forces owners of small firms to calculate their taxes twice, once under the regular system and once under the AMT. Business owners must then pay whichever calculation produces the highest number. The hours lost are enormous and the revenue gained for the Treasury is minimal. NFIB suggests solving this problem by increasing the AMT exemption from $40,000 to $60,000.

Create a Zero Corporate Rate for Small Firms

The personal exemption effectively creates a zero individual tax rate for poor individuals. This same line of thinking should be applied to small corporations that are barely making it. Corporations earning less than $10,000 a year should not have to pay any tax on those earnings. This lower corporate rate will increase the funds available to the business owner to reinvest back into the business.

Simplify the Home Office Deduction

The U.S. Supreme Court's Soliman decision greatly complicated the rules governing who can take the home office deduction. Even the pre-Soliman rules were complicated for many small business owners. NFIB recommends that the rules governing the home office deduction be simplified so that any business owner who devotes a room exclusively to business use and uses that room regularly to operate a trade or business be allowed to take the deduction.

Encouraging New Hiring and Business Growth

Small businesses have consistently created most of the new jobs in this country. These jobs are created by new businesses coming into existence and by small firms who grow rapidly. Unfortunately, the tax code punishes these businesses by heavily taxing labor and hitting fast growing firms with high individual tax rates. In order to encourage new hiring and business start-ups, NFIB recommends Congress enact the following provisions.

Payroll Tax Credit for New Hires

For every new employee, business owners must pay FICA taxes, unemployment insurance, and workers' compensation. Although these taxes were all created for laudable purposes, their net result is to dramatically increase the cost of hiring workers.

Few new firms can afford to hire all the workers they can use. The costly taxes layered on top of the workers' salaries do not make it easier. NFIB recommends giving small business owners a payroll tax credit for new hires that offsets FICA taxes. By making employment less expensive, this new credit will remove a major impediment to hiring new workers. It will also help bring the cost of labor more in line with the cost of capital, helping to reduce the incentive for business owners to automate and replace people with machines.

Low Income Tax Rates

Seventy percent of all new jobs created between 1987-1992 were created by the fastest growing 4% of firms in the country.[6] These businesses are found in every industry and are scattered throughout the country. The one thing these businesses have in common is that they earn high profits and the owners of the businesses reinvest those profits back into the business.

Unfortunately, the tax code currently taxes business profits even if they are reinvested back into the business. The accrual method of accounting and depreciation rules limit the amount of reinvestment the business owner can deduct when the investment is made. The high tax rates of the 1993 tax bill exacerbated this problem. NFIB recommends helping these growing firms by either lowering the income tax rates or by at least not subjecting business profits, that are reinvested back into the business, to income tax.

Encouraging Business Transfers and New Business Formation

A number of entrepreneurs follow an interesting pattern. They enjoy starting new ventures but do not enjoy running them. As a result, they end up starting a business, selling the business and using the profits from the sale to start another business. This constant creation of new businesses has a very beneficial effect on our economy. Unfortunately, the tax code punishes this type of conduct. NFIB recommends encouraging these entrepreneurs to start new firms by making the following changes to the tax code.

Create a $200,000 Capital Gains Lifetime Exemption

Business owners who sell their businesses must pay a capital gains tax on the value of the business even if they take the proceeds of the business and immediately reinvest them in a new business. This severely limits the liquidity of business transactions and limits the ability of our nation's most talented entrepreneurs to set up a series of new businesses. NFIB recommends that a $200,000 capital gains exemption be created to encourage business owners to shift investments from one business to another.

Index Capital Gains

The business is often the life savings of the business owner. Business owners work hard to create these profits, and they will frequently reinvest most of the business's profits back into the business. 80% of new small business owners worked 50 or more hours per week.[7] Congress should encourage this behavior because it maximizes the business's potential. Unfortunately, current law punishes this type of investment because the business owner will be taxed on the increased value of the business that is attributable to inflation. When it comes time to sell the business and reinvest in a new business or retire, business owners should not be forced to pay tax on inflation. Indexing capital gains will ensure that business owners pay tax on only the true increase in value.

Lower Estate Taxes

According to NFIB surveys, one of the top three reasons Americans go into business for themselves is to create something that will help provide for their families.[8] The prospect of creating a family business is a major driving force behind the actions of many small business owners. Unfortunately, current estate tax law makes it very unlikely that a business will be able to survive the transition between generations. In fact, estate taxes are so high that only 7 percent of family businesses survive two transitions between generations.

Current law provides little relief for business owners who have an operating business that they want to pass on to their children. They can take advantage of the $600,000 unified credit and the $10,000 in annual gifting, but neither of these provisions are very helpful in a business context. Estate tax law requires that everything be added into the estate. As a result, the heirs of business owners are not only taxed on the value of the business, but also on the value of the home, car and any other property their parents may have owned. The $600,000 unified credit does not go very far.

Allowing business owners to give away $10,000 chunks of their business each year is also not a very good option. Business owners will often not know if their children are interested and/or qualified to run the business. By the time their interest and qualifications are shown, the business owner is late in life and has little time to give a significant part of the business to the children.

Businesses providing jobs and opportunity to the community should not have to be sold just because the owner dies. Yet that is frequently the result because the estate tax rates are so high. A business worth $1 million will owe $153,000 in estate taxes. A business worth $3 million will owe almost $1.1 million in estate taxes. Very few businesses can afford to pay these estate tax bills and continue to operate.

Businesses should not be punished for being family-owned. NFIB urges Congress to enact legislation that will allow anyone who inherits a family business to defer paying estate tax on the value of the business until it is sold outside of the family. Once a large part of the business is sold outside of the family, the estate tax would become due.

CONCLUSION

The tax changes listed above will help small businesses get started, help them grow and encourage entrepreneurs to use the increased value of a business to start another. Our nation relies on small business owners to provide about two-thirds of all net new jobs. Targeting tax relief to this sector of our economy will maximize the number of Americans who can go to work and be productive, tax-paying members of society. Small business tax relief will not only assist small business owners and their employees, but it will also improve the economy as a whole as more American's go to work.

Endnotes

1. Small Business Problems and Priorities. William J. Dennis, Jr. The NFIB Foundation p. 9. The five tax related issues were: federal taxes on business income, FICA (social security taxes), state taxes on business income, property tax/rent costs, frequent changes in federal tax laws.

2. A Small Business Primer. William J. Dennis, Jr.; The NFIB Foundation, p. 16.

3. Small Business Problems and Priorities. William J. Dennis Jr.; The NFIB Foundation, p. 9.

4. New Business in America. Cooper, Dunkelberg, Woo, Dennis; The NFIB Foundation 1990, p. 21.

5. New Business in America. Cooper, Dunkelberg, Woo, Dennis; The NFIB Foundation 1990, p. 46.

6. Who's Creating Jobs?. David Birch, Cognetics, Inc.

7. New Business in America. Cooper, Dunkelberg, Woo, Dennis; The NFIB Foundation 1990, p. 34.

8. A Small Business Primer. William J. Dennis, Jr., The NFIB Foundation 1993, p. 31.

Stratford Technologies, Inc. / 8 Poplar Terrace / Somerdale, NJ 08083

September 7, 1993

Janice Mays
Chief Counsel and Staff Director
Subcommittee on Select Revenue Measures
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Bldg.
Washington, D.C. 20515

Dear Chief Counsel Mays:

Please include this letter in your hearing record on the proposal to repeal the safe harbor under section 530 of the Revenue Act of 1978 (relating to the classification of workers as independent contractors) for construction industry employers. This proposal is treading on dangerous ground. Although I am not in the construction industry, I nevertheless have grave reservations about this legislation.

My understanding is that when 530 was originally passed, it was intended to protect those taxpayers who IN GOOD FAITH could not discern whether there was an independent contractor relationship or an employment relationship. This was necessary because of

1. the complexity of modern economic situations,
2. the difficulty of applying old English common law to them, and
3. abuses by the IRS.

When 530 protection was taken from technical service workers working through third parties through section 1706 of the 1986 Tax Reform Act great problems were created in my industry. (My written testimony to your committee last year is referenced hereby.) Those problems include:

1. distortion of efficient markets when UNCERTAINTY of IRS actions is used by competitors to undermine entrepreneurial activity of legitimate tax paying firms and workers,
2. loss of carryover of benefits for project workers (workers who switch job sites frequently [as employees] are unable to continue medical coverage of pre-existing conditions, unable to continue vesting of pension rights, etc.),
3. excess payments by employers who are forced to pay higher unemployment compensation insurance premiums, higher social security taxes (because the employer portion is not subject to rebate when overpaid by two or more employers), etc.,

4. loss of utility of corporate veil protection for workers whose personally owned corporations might not be considered sufficient qualification for tax-wise independent contractor status

   (it is difficult to maintain corporate veil protection for a one-worker-owned corporation when the IRS has no procedure for allowing a client to pay withholding tax on the money paid to the corporation for services performed by its employee), and

5. threat of DOUBLE TAXATION (through withholding assessments) to client/employers and broker/employers when TAXES ARE PAID by workers as independent contractors but the IRS later rules retroactively and without guidance from Congress or precedent that an employment relationship rather than independent contractor relationship existed.

Revocation of 530 protection is something that is tempting to those looking for offsetting measures for their spending. It was unfair for this to be done to my industry and it is unfair for the construction workers to be told to join us.

If the IRS is not able to collect the taxes that it should be collecting, Congress should consider change the reporting rules to provide additional controls.

> 1992's HR 5011 attempted to do this. Unfortunately, by extending the 1099 reporting to corporations and to annual total payment amounts greater than only $100, it could greatly increase the paperwork burden, and thereby cause clients to avoid doing business with smaller service corporations in favor of large ones (because one 1099 is easier to fill out than 1000 1099s). THIS DISCRIMINATION AGAINST SMALL BUSINESS could be countered by allowing IRS certified constractors who are subject to additional audit rules to provide 1098 information returns to clients. If this could be optionally done in lieu of 1099 reporting by clients it could reducing the burden on clients enabling the small contractor to market on an equal tax-issue footing with with the larger contractor.

I know of no studies showing that the 1986 Tax Reform Act's section 1706 gained any revenue for the federal government. Please examine this proposal very closely to see if this is yet another attempt to 'pay' for someone's pet project on the backs of working people with funny money that may never be seen.

Sincerely,

William R. Patterson

William R. Patterson

Statement of the United Brotherhood of Carpenters and Joiners of America, AFL-CIO, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, Supporting the Repeal of Section 530 of the Revenue Act of 1978 as Applied to the Construction Industry.

1. Introduction

The United Brotherhood of Carpenters and Joiners of America, AFL-CIO (UBC) supports language proposed by the Subcommittee that would repeal the "safe harbor" provisions of Section 530 of the Revenue Act of 1978 for construction industry employers. Investigations by several Congressional committees, the General Accounting Office, and the Internal Revenue Service clearly demonstrate that Section 530 is widely used by employers to misclassify employees as "independent contractors," thereby avoiding both taxes and employee benefits. The Subcommittee's proposed language would close this loophole, resulting in increased government revenue, improved conditions for construction industry employees, and relief for fair employers.

2. Section 530 allows employers in the construction industry routinely to misclassify employees as independent contractors.

Employers in the construction industry are engaging in a widespread practice of intentionally misclassifying employees as independent contractors.[1] Under Section 530, employers who misclassify employees are protected from IRS sanctions where (1) the employer relies on judicial precedent or IRS rulings; (2) the employer has previously been audited by the IRS, even if the audit did not concern classification;[2] or (3) classification of workers as independent contractors is a recognized industry practice.

While there are no precise statistics on misclassification in the construction industry, investigations by committees of Congress and the media confirm the existence of a widespread pattern of abuse:

- IRS data show that in one district, 20% of employers in the residential construction industry failed to file Forms 1099 at all, and 64% misclassified employees as contractors, resulting in a revenue loss of $3.8 million.[3]

- General contractors have one of the highest misclassification rates of any industry group. One IRS analysis revealed over 6,000 Forms 1099 that could not be matched to taxpayers' accounts, resulting in a revenue loss of $91 million.[4]

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[1] According to a 1989 General Accounting Office report, 38% of all employers who file information returns with the IRS misclassify their employees. Tax Administration: Information Returns Can be Used to Identify Employers Who Misclassify Workers, GAO/GGD 89-107 (1989) at 5.

[2] The prior audit provision has been criticized for creating situations where similarly situated workers will be employees of one employer and independent contractors of another as a result of audits unrelated to classification. Moreover, Section 530 "locks in" these disparities by preventing the IRS from issuing regulations or rulings on employment status. See Statement of Marshall V. Washburn, Compliance 2000 Executive, Internal Revenue Service, before the Subcomm. on Commerce, Consumer, and Monetary Affairs, House Comm. on Government Operations, June 8, 1993 [Washburn statement], at 3.

[3] Id. at 7.

[4] Id. at 8.

- An estimated 85 to 90 percent of residential construction employees in the state of Connecticut are misclassified.[5]

- Construction employers in California routinely pay workers in cash and either do not file Forms 1099, or file using false addresses and social security numbers. The UBC estimated in 1991 that these practices cost the federal government $26 million in lost revenue for this one industry.[6]

- An IRS investigation of 50 construction firms in Lake Havasu City, Arizona found that 47 failed to comply with employment tax-withholding requirements.[7]

- Construction employers routinely instruct employees in methods of tax avoidance.[8]

3. Repeal of Section 530 will increase tax revenue.

A series of Congressional investigations over the past four years clearly shows both the loss of billions of dollars in tax revenues annually because of misclassification, and the need for increased IRS enforcement efforts.

The most-cited IRS data show that in 1984, employers misclassified over 8 million workers, resulting in $1.6 billion in lost revenue. This estimate is only "the tip of a potentially enormous iceberg,"[9] as it does not include employers who classified all their workers as independent contractors.[10] The IRS found that nine percent of these 8 million employees (who receive 14 percent of the total compensation) fell within the scope of Section 530. Section 530 protected over 70,000 employers, one-half based on the industry practice exception and nearly half based on the prior audit exception.[11]

There is another reason why the IRS's estimates of revenue lost because of Section 530 must be conservative: these estimates assume that enforcement will continue at its current, relatively low, level.

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[5] Exploiting Workers by Misclassifying Them as Independent Contractors: Hearing Before the Employment and Housing Subcomm. of the Committee on Government Operations, 102d Cong., 1st Sess. 79 (1991)[hereinafter Exploiting Workers](statement of John W. Cunningham, Labor Co-Chair, Carpentry Industry Partnership).

[6] Exploiting Workers at 48 (testimony of Michael Munoz, Bay Counties District Council of Carpenters).

[7] Bill Goodykoontz, Mohave County Tax Cheats, Beware, Arizona Republic, Feb. 3, 1991.

[8] Statement of David Bucnis, Journeyman Carpenter, Connecticut, before the Subcomm. on Labor, Senate Comm. on Education and Labor, June 15, 1993; Statement of Earl Thomas, UBC Business Agent, Texas, before the Subcomm. on Labor, Senate Comm. on Education and Labor, June 15, 1993; Exploiting Workers at 15 (statement of Michael Hedden, Carpenter, Florissant, Missouri).

[9] Committee on Government Operations, U.S. House of Representatives, Contractor Games: Misclassifying Employees as Independent Contractors, H.R. Rep. No. 1053, 102d Cong., 2d Sess. 6 (1992) [hereinafter Contractor Games].

[10] Id. at 5 (reporting findings from the IRS's 1989 "Strategic Initiative on Withholding Noncompliance Employer Survey."). "[T]he voluntary reporting percentage for misclassified workers receiving information documents (Forms 1099) from their employers was 77.2 percent. This percentage dropped to 28.2 percent when no information return was filed by the employer." Washburn statement at 4.

[11] Contractor Games at 8.

There is no question that Section 530 "hamstrings" effective IRS enforcement of intentional employer misclassification.[12] From 1979 to 1988, the percentage of employment tax returns examined fell from 0.43% to 0.09%. According to IRS officials, "the decline in these examinations occurred because of restrictions on IRS's authority to correct all misclassifications, due to Section 530 of the Revenue Act of 1978."[13] The IRS simply does not find it worthwhile to pursue employers who can escape punishment through the Section 530 loophole.[14]

The FY 1994 Treasury appropriations legislation, referred to conference on August 3, 1993, includes funding for the IRS to hire and train additional examiners to enforce classification rules in the construction industry.[15] Together with the repeal of Section 530, this measure may be expected to produce significant recuperation of lost revenue from construction industry employers who misclassify their employees.

4. Tax administration has improved where Congress has denied Section 530 protections to industries where there was widespread misclassification

Repealing the "safe harbor" provisions of Section 530 for a specific industry is not unprecedented. In 1986, Congress responded to widespread concerns of misclassification in the technical services industry by enacting Section 1706 of the Tax Reform Act of 1986, which denied section 530 protection to technical services placement firms that provided referrals for engineers, programmers, etc. Section 1706 has improved tax administration by permitting the IRS to issue guidance with respect to certain workers and by denying the Section 530 safe harbors to employers within its coverage.[16]

5. Repeal of Section 530 provisions will benefit workers in the construction industry.

The "safe harbor" provisions of Section 530 encourage employers to evade payment of social security, unemployment, pensions, medical insurance, and workers compensation.[17] Classification as independent contractors also strips away the protections of the federal laws that regulate overtime work, protect workplace safety and health, prohibit discrimination, and provide for collective bargaining. The results for both individual workers and for society are devastating:

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[12] Exploiting Workers at 135 (testimony of Marshall V. Washburn, Deputy Assistant Commissioner (Examination), Internal Revenue Service).

[13] GAO/GGD-89-107 at 4. The GAO criticized the IRS for relying almost exclusively on third-party leads and failing systematically to compare taxpayer returns against information returns filed by employers. Id. at 3-6.

[14] In the IRS's 1986-87 sample survey, nearly half of the penalties recommended against misclassifying employers ($6.7 million out of $16.7 million) could not be assessed due to the safe harbor provisions. GAO/GGD-89-107 at 7. As the head of the IRS's examinations unit told Congress, "it tends to cast a shadow over our agents' enforcement zeal, if you want to say, because they realize, when they get into many of these cases, the employer will claim section 530 relief." Exploiting Workers at 136 (testimony of Marshall V. Washburn, Deputy Assistant Commissioner (Examination), Internal Revenue Service).

[15] Treasury, Postal Service, and General Government Appropriations Bill, 1994, H.R. Rep. 127, 103d Cong., 1st Sess. (1993).

[16] Exploiting Workers at 108 (statement of Marshall V. Washburn, Deputy Assistant Commissioner (Examination), Internal Revenue Service). See also Statement of the Information Technology Association of America before the Subcomm. on Commerce, Consumer and Monetary Affairs, House Comm. on Government Operations, June 8, 1993.

- David Zaccardi, a Minnesota construction worker, fell off a roof and broke his back, neck, and pelvis. Because his employer claimed that he was an independent contractor, Zaccardi was left without either workers' compensation or medical insurance, and was forced to go on public assistance.[18]

- A survey of the east Portland metropolitan area found that 34% of residential construction workers had no unemployment insurance coverage.[19]

- The State of Connecticut's bankrupt unemployment insurance system borrowed $68 million from the Federal government. Employers who misclassify their employees shift the entire burden of repaying this debt to fair employers.[20]

- When Florida attempted in 1989 to salvage its near-bankrupt workers' compensation system, construction firms threatened to reclassify their employees as independent contractors. "The result would be even higher insurance premiums for companies in the system, while fewer workers would be covered if they are injured on the job."[21]

- Even persons who unknowingly hire independent contractors may end up bearing the costs of misclassification. When an uninsured contractor hired by a Portland, Oregon couple was injured on the job, the couple's homeowners insurance was cancelled. The Oregon Construction Contractors Board has received "thousands" of similar complaints from homeowners.[22]

As the House Committee on Government Operations concluded,

> "[F]or most workers, misclassification as contractors is seriously disadvantageous. The loss of financial benefits and of the statutory and voluntary protections which are provided to employees can be devastating in cases of illness, unemployment, and retirement."[23]

Misclassification not only deprives employees of rights and protections granted by law; by ripping away the social safety net of pensions, workers compensation, unemployment and health insurance, it shifts the costs of caring for unemployed, sick, or disabled workers and their families from the employer to the public. "[S]ociety--Federal, State, and local governments and the voluntary sector--must plug the holes in the safety net when disaster overtakes misclassified workers who have been deprived of the protections they should have had."[24]

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[17] Contractor Games at 3.

[18] Jill Hodges, Workers' Comp Use of Independent Contractors Causing Problems When They Get Hurt, File Claim, Minneapolis Star-Tribune, Apr. 14, 1993.

[19] Exploiting Workers at 76 (statement of Michael D. Hobbs, management co-chair, Carpentry Industry Partnership).

[20] Id. at 68.

[21] Adam Yeomans, Workers' Comp Stirs Up a Fuss, Orlando Sentinel, Oct. 22, 1989, at D1.

[22] Stuart Wasserman, Contracting With Caution, The Oregonian, Dec. 15, 1991, at H1.

[23] Contractor Games at 7.

The impact of this cost shifting is exacerbated by the national health care crisis. As fair employers are forced to stop providing health insurance to their employees in order to compete, the taxpayers are stuck with the bill for uninsured workers' medical care. The President's plan for universal health care coverage, which mandates employer payment of insurance premiums, clearly does not intend to leave large numbers of workers uninsured because their employers label them "independent contractors."

6. Repeal of Section 530 provisions will benefit law-abiding employers in the construction industry.

Misclassification creates a huge competitive disadvantage for construction industry employers who try to obey the law. Estimates of the total costs saved by the employer who misclassifies an employee as an independent contractor range from 23.15% to 37%[25] (as noted above, employers "save" by passing on their costs to the taxpayers). In the intensely competitive, recession-pressed construction industry, such cost disparities make it easy for employers who misclassify employers to underbid their competition, and difficult for employers who do not misclassify to resist the pressure to cut costs by illegal means.[26] As one Minnesota construction employer, who estimated that 70 percent of his competitors hired only independent contractors, put it: "I really believe that most of the contractors [firms] want to do things right, but they can no longer afford to do it."[27] Repealing Section 530 for the construction industry will restore a level playing field for employers who obey the law.

7. Conclusion

The United Brotherhood of Carpenters supports the Subcommittee's proposal to repeal Section 530 of the Revenue Act of 1978 for construction industry employers. By closing a loophole that rewards employers who misclassify their employees as independent contractors, the Subcommittee's proposal will increase tax revenue, help restore workers' economic security, and promote fair competition.

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[24] Id.

[25] Exploiting Workers at 192 (statement of Peter A. Cockshaw, publisher, Construction Labor News); Id. at 72 (statement of Michael D. Hobbs, management co-chair, Carpentry Industry Partnership); Contractor Games at 3.

[26] A number of states, including Connecticut, California, Oregon, and New Hampshire, have enacted laws creating a private right of action for construction industry employers who are the victims of underbidding by contractors who intentionally misclassify employees to reduce costs. See 1990 Conn. Pub. Acts 273; 1991 Cal. Stat. 1754; 1991 N.H. Laws 376; 1991 Ore. Laws Ch. 323. The House Government Operations Committee has recommended a similar provision in federal law. Contractor Games at 10.

[27] Jill Hodges, Workers' Comp Use of Independent Contractors Causing Problems When They Get Hurt, File Claim, Minneapolis Star-Tribune, Apr. 14, 1993, at 1D.

STATEMENT OF THE HONORABLE GERRY E. STUDDS SUBMITTED TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES

September 23, 1993

I would like to take this opportunity to urge this Subcommittee's support for H.R. 2441, which I introduced earlier this year. Several weeks ago, I testified on the bill's provisions dealing with the deductibility of water and sewer fees. I would now like to share with you my views on the measure's offset provisions.

Under current tax law, polluters who pay fines or penalties for violations of environmental laws cannot deduct these amounts from their tax liability. They can, however, write off as a business expense any sums they are required to pay through court or administrative settlements to compensate for environmental damage.

In other words, the law now allows those responsible for cleaning up oil spills, chemical discharges and other pollution to shift those costs to the taxpayers. For example, in 1991 Exxon agreed to pay $900 million in restoration payments for damages to the Alaskan shoreline from the Exxon Valdez oil spill. The company is able to call this a "business expense" and take a deduction for this amount.

Other examples abound. Ciba-Geigy, the giant pharmaceutical company, was ordered by a federal court to pay $120 million for soil and groundwater contamination at its McIntosh facility. Several companies located in New Bedford, Massachusetts will together pay $100 million for restoration and response costs for PCB contamination of New Bedford Harbor. This year Texaco paid almost $9 million in clean-up costs for an oil spill in Puget Sound.

These are just a few examples of the environmental polluters who have been able to deduct these expenses from their tax liability in the same way they deduct their employee health benefits payments or their office supply costs. In eliminating this deduction, H.R. 2441 will do two important things.

First, it will add to the U.S. Treasury millions now being lost annually to the treasuries of corporate polluters. Second, it will create an incentive for companies to ensure that their corporate activities will not harm the environment. The current system encourages businesses to take risks because ultimately they are not responsible for the full costs of restoration for any damage they may cause.

Some have argued that disallowing this deduction could discourage taxpayers responsible for such damages from agreeing to make compensatory damages. It is important to note that the ability to take a deduction for compensatory damage payments is only one factor in a company's decision to negotiate an agreement with a regulatory agency. It is more likely that the most significant factor is the prospect of burdensome legal and other expenses that would be incurred by protracted litigation -- the only other alternative to a negotiated settlement.

In short, this bill would overturn current law that says that the costs associated with cleaning up pollution resulting from a corporation's activities are "ordinary and necessary" business expenses and therefore deductible. Characterizing them in this fashion essentially rewards polluters. This policy should not be embodied in federal tax law and I urge support for its elimination.

Alliance Exchange

September 10, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways & Means
U. S. House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Re: "Like-Kind" Proposal Before Subcommittee
on September 14, 1993

Dear Ms. Mays:

We are writing in response to the proposal to come before the House Ways and Means Subcommittee on September 14, 1993 regarding the amendment of I.R.C. 1031 to define "like-kind" to mean "similar or related in service or use."

We are in strong opposition to this proposal. This proposed change would ring the death-toll for most I.R.C. 1031 exchanges, and would further break the back of the fragile real estate industry. The current "like-kind" test under I.R.C. 1031 has allowed exchangors to plan and complete their transactions without administrative difficulty and/or arbitrary court decisions and rulings. We do not believe that the resulting increase in tax litigation cases involving the proper definition of "similar or related in service or use" will be in the best interest of the real estate industry, the taxpayer or the Internal Revenue Service.

In conclusion, Alliance Exchange Group, Inc. is in total opposition to the proposed amendment to I.R.C. 1031, and strongly urges its elimination from the Subcommittee's current agenda.

Sincerely,

ALLIANCE EXCHANGE GROUP, INC.

Deanna F. Burton

Deanna F. Burton
President

DFB:bf

Mail

Alliance Exchange Group, Inc
2030 East Fourth Street, Suite 120, Santa Ana, CA 92705 / (714) 543-2469 / Fax (714) 543-2540 / (800) TOP-1031

AMERICAN EQUITY EXCHANGE, INC.

September 10, 1993

Ms. Janet Mays
Chief Council & Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office
  Building
Washington, D.C. 20515

RE: Select Revenue Measures Subcommittee
September 14, 1993 Hearing

Dear Ms. Mays:

I am secretary and general counsel for American Equity Exchange, a qualified exchange intermediary with its headquarters in Dillon, Montana. Our company serves taxpayers, primarily in Montana and the Rocky Mountain region but has acted as an exchange intermediary in many interstate transactions throughout the United States. American Equity Exchange, Inc. is a member of the Federation of Exchange Accommodators.

I join in the comments made by Andrew G. Potter, President of the Federation of Exchange Accommodators, in his letter to you of September 3, 1993. Mr. Potter specifically addressed the proposal to amend Internal Revenue Code Section 1031 to substitute the language "similar or related in service or use" for the current "like kind" terminology contained in the section. It appears to those of us working in the trenches, that much of the fine work in promulgating regulations which brought some certainty to 1031 transaction would be negated by the inclusion of the proposed terminology. The new regulations when coupled with the well understood "like kind" test have been helpful in promoting certainty in 1031 transactions. Prior to the new regulations, the lack of certainty and application of the case law had a chilling effect on use of Section 1031 in real estate transactions.

I believe the implementation of the proposed terminology would simply create more litigation. In these times of attempting to streamline government and trying to eliminate the waste of taxpayers dollars, increased litigation and the cost associated with the increase does not serve the best interests of the IRS or the taxpayers of the country.

American Equity Exchange, Inc. reiterates its opposition to the proposed amendment to Internal Revenue Code Section 1031. I strongly urge you to do everything in your power to eliminate the proposed amendment or any similar amendments from the subcommittee's current or future agendas.

Thanks very much.

Sincerely,

MAX A. HANSEN

MAH/glm

1828 L Street, N.W.
Washington, DC 20036
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FAX 202/223-5843

Statement of American Land Title Association
Hearing on Miscellaneous Revenue Proposals
on Proposal to
Modify the Standard for Nonrecognition of Gain on Exchanges of Like-Kind Property

before the
Select Revenue Measures Subcommittee
Committee on Ways and Means
U. S. House of Representatives
September 23, 1993

Summary: The American Land Title Association[1](ALTA) appreciates the opportunity to submit testimony on a proposal to amend the like-kind exchange rules to require that the property received in a like-kind exchange under code Section 1031 must be "similar or related in service or use" to the property exchanged, except in the case of condemnations. For further information on the ALTA position please contact Ann vom Eigen, ALTA's Legislative Counsel at (202) 267-3671, ext. 214.

Congress has taken steps in the recently enacted Omnibus Budget Reconciliation bill, such as by the limited relaxation of the passive loss provisions, to encourage revival of the real estate market. The proposed modification of Section 1031 would undermine this effort. It both threatens the present precarious recovery of an integral element of the national economy, the real estate market, and would eliminate the many public policy benefits received from like-kind exchanges. ALTA believes that current law is equitable, and that imposition of a "similar or related in service or use" test (1) would be extremely difficult if not impossible to administer, (2) would not result in significantly increased revenue to the Federal government, and (3) would unfairly penalize real property exchanges in contrast with other assets.

Background: ALTA members are involved in virtually all mortgage-financed residential real estate transactions in the United States, and are involved as title insurers in most commercial transactions. As recognized specialists in real estate transfers, we are often called on to facilitate like-kind exchanges, for both commercial and residential real estate. Many of these exchanges, such as those of environmentally sensitive lands for developable properties, concurrently implement a public policy goal, and achieve an economically efficient use of land and property.

Current Law: Acknowledgement that an exchange of like-kind property has altered neither (1) the level, (2) the type, nor (3) the economic position of a taxpayer has been an element of the tax code since 1924. Congress has always recognized that gain or loss should not be taxed currently when property held for productive use in a trade or business is exchanged for similar property. Further, in general, no actual cash is generated during the transaction to pay a tax. Current law does equitably require taxation when cash or boot exceeds the transferred property's adjusted basis.

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[1] The American Land Title Association membership is composed of 2,000 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles to protect owners and mortgage lenders against losses from defects in titles. These firms and individuals employ nearly 100,000 individuals and operate in every county in the United States.

Imposition of a Similar Use Test is Unworkable: Congressional imposition of a "similar or related in use" test at this time would impose a standard which is not definitive. Lack of a clear standard will lead to difficulties in interpreting and imposing the restriction.

To date, six circuits and the IRS have developed four separate standards in imposing the "similar use" test to owner-lessors in involuntary conversions.[2] Those tests focus on the management activities involved, the amount and kinds of service rendered to a tenant, and the business risks associated with the lease. In fact, the significance of the physical characteristics of the property relevant in a "functional use" test has yet to even be addressed by the courts. Consequently, imposition of this uncertain standard will undoubtedly result in substantial litigation.

Second, the "similar or related use" test is categorically fact based. The global focus on "all the circumstances"[3] to determine similar use will by definition require an exhaustive examination of the facts in each case. Thus, the standard actually encourages litigation, by pointing out that " primary weight" is given to the conclusions of the trier of fact.

Imposition of a Similar Use Test will Not Generate Significant Revenues: Enactment of proposals substantially narrowing the current law standard would absolutely eliminate many economically beneficial exchanges of both commercial and residential real estate. The dynamics of the real estate market warn that narrowing the like-kind exchange rules will not merely chill transactions and convert them to simple taxable sales. Rather, these transactions will not occur.

First, many transactions will simply not go forward because taxing exchanges which meet a like-kind, but not a similar use, test will mean taxing transactions where no cash is received. As there would be no funds generated to pay a tax, there would be a strong disincentive to engage in such a transaction.

Second, narrowing the definition would result in renewed interest in other means of enjoying the benefits of appreciation in property, namely, through refinancing.

Third, taxable sales now generated under current law rules to create a suitable replacement property would not develop. Taxable sales now often occur as a result of a like-kind exchange or as part of a multiple party exchange. These transactions are generated when the owner of a property will not sell because of the tax consequences, and a potential cash seller seeks a like-kind exchange property. Thus, current tax revenues would decline, as this currently taxed derivative category of transactions also would not occur.

Modification of Section 1031 Unfairly Penalizes Real Property Assets: Section 1031 is the nonrecognition provision for exchange of property on a tax-deferred basis. Nonrecognition provisions for other assets, e.g. stock, exist throughout the tax code. Prohibiting transactions which are real property based, while supporting trading of other types of assets effectively creates an incentive to place resources in other assets to the detriment of real property. As mentioned above, the real estate market has been in decline since enactment of the 1986 Tax Act. Jeopardizing the current precarious recovery through changes to the like-kind exchange rules is ill-advised.

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[2] Liant, 9 AFTR 2d 1557, 1560 (2nd Cir. 1962), which has been applied in the Second, Sixth, and Seventh Circuits, and by the IRS in Rev. Rul. 64-237; Loco Realty, 10 AFTR 2d 5359, 5366 (8th Cir. 1962); Filippini, 11 AFTR 2d 1720, 1722 (9th Cir. 1963); and Steuart Bros.; 3 AFTR 2d 318 (3rd Cir. 1958)

[3] Filippini, id.

September 22, 1993

Ms. Janice Mays, Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

RE: Subcommittee on Select Revenue Measures

Dear Ms. Mays:

Regarding the hearings on a proposal to amend the like kind exchange rules, I am writing to encourage the subcommittee to maintain the current regulations and procedures, and better clarify Internal Revenue Code Section 1033.

The concern of not being assured of having a valid exchange, as well as the proposal to curtail the current options for acquiring a variety of properties, may cause investors to choose to hold on to the property they now have. This will be devastating to the fragile real estate industry recovery - both nationally and here in California - and will not be beneficial to the United States Treasury.

Sincerely,

Barbara Bishop

Barbara Bishop
100 Hurlbut Street, #3
Pasadena, CA 91105-3118

cc: C. Anthony Phillips, President, Downstream Exchange Company

EQUITY ADVANTAGE
INCORPORATED
A REAL ESTATE EXCHANGE SERVICE

Thursday, September 9, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C.
20515

Re: Like-Kind Rule Affecting Section 1031

Ms. Mays:

We are writing to indicate our opposition to the proposal to amend the like-kind exchange rules under Section 1031. We have enclosed some reasons to back our opposition to this bill.

1) Any change to Section 1031 would adversely affect our business climate because it will limit the ease of making a like-kind exchange of real estate. We were in opposition to the same proposal made under Section 11601 of the Revenue Reconciliation Act of 1989, which was ultimately eliminated from the Act.

2) Putting limits on the like-kind rule will discourage a healthy real estate market. Many people are able to exchange and reinvest in the real estate market, because they have the flexibility to acquire any property held for investment purposes. A change in the rules will lead to less activity in the market which will likely affect many of the companies who serve the real estate communities.

3) The like-kind rule as it stand has been relatively easy to administer, and has accounted for many properly planned transactions by thousands of exchangors. On the other hand, the "similar or related in service or use" rule under IRC Section 1033 is difficult for many to understand and has caused a litany of of contradictory and confusing court decisions.

4) We strongly urge the elimination of the proposed amendment from the Subcommittee's agenda to promote a healthier real estate market in these tough economic times.

Thank you for your attention.

Cordially,

Lonnie C. Nielson
Director of Operations

Thomas N. Moore
Vice President

David S. Moore
President

Equity Advantage, Incorporated
Exchange Facilitation Services

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September 10, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

This company was formed in 1986 and continues to operate as a professional accommodator in tax deferred exchanges under Internal Revenue Code Section 1031.

It is my understanding that a proposal has been placed before the committee to amend the code, substituting "a similar or related in service or use" requirement for the current "like-kind" requirement in the exchange of property. Surely, this amendment is ambiguous by its very nature, and forbodes future disputes, often to the point of litigation, thereby rendering a disservice to both the Internal Revenue Service and the taxpayer.

Hopeful that this proposal can be quashed, I am

Sincerely yours,

Frank C. Huntsman,
President

FCH:psc

cc: Andrew G. Potter, President
    Federation of Exchange Accommodators

FEA
FEDERATION OF
EXCHANGE
ACCOMMODATORS

September 3, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Select Revenue Measures Subcommittee
September 14, 1993 Hearing

Dear Ms. Mays:

The Federation of Exchange Accommodators is an organization composed of entities and their primary advisors, which participate as professional accommodators in tax deferred exchanges under Internal Revenue Code §1031. The FEA has in excess of eighty (80) members, located in twelve (12) states, and has been formed to promote interaction and discussion of ideas and innovations in the industry, to provide for and promote the establishment of ethical standards of conduct, to offer education to both the industry and the general public, and to work for the development of a uniformity of practice and terminology within the exchange industry.

This letter is written in specific response to the proposal to amend I.R.C. §1031 to substitute a "similar or related in service or use" requirement for the current "like-kind" requirement to which is scheduled to be discussed at the above referenced hearing.

The FEA has previously expressed its opposition to this proposal when the same was included in Section 11601 of the Revenue Reconciliation Act of 1989 (H.R. 3150) as passed by the House of Representatives on September 28, 1989. As you are aware, this proposal was eliminated from the Act ultimately as passed and later signed into law.

The FEA continues to strenuously oppose this proposal. The proposed change would substantially alter I.R.C. §1031 and would detrimentally effect thousands of transactions involving commercial, residential, industrial and agricultural real estate. This could be especially devastating to the fragile real estate industry as it struggles toward an economic recovery.

3857 Birch Street, Suite 111 • Newport Beach, CA 92660-2660 • (714) 752-8582

The proposal would alter the longstanding requirements for a tax deferred exchange under I.R.C. §1031 by replacing the existing "like-kind" test with a "similar or related in service or use" test borrowed from I.R.C. §1033. The "like-kind" test has been relatively easy to administer and has resulted in few litigation issues. In short, the "like-kind" test has allowed taxpayers to plan their transactions with a high degree of certainty as to an ultimate result. The "similar or related in service or use" test under I.R.C. §1033, on the other hand, has presented an ongoing administrative difficulty and has resulted in a litany of contradictory, confusing and often arbitrary court decisions and rulings. As a result, the "similar or related in service or use" test has prevented taxpayers from being able to properly plan their transactions. In fact, I.R.C. §1033(g) specifically contains an alternative "like-kind" test for real property held for productive use in trade or business or for investment as an outgrowth of these problems.

There continues to be no justification for the replacement of the certain "like-kind" test with the uncertain "similar or related in service or use" test. Such a replacement can only result in a monumental increase in tax litigation cases involving the vagaries of the proposed replacement. This type of result is not in the best interest of the administration of the I.R.C. by the Service.

In conclusion, the FEA categorically opposes the proposed amendment to I.R.C. §1031 and strongly urges its elimination from the Subcommittee's current and future agendas.

Very truly yours,

FEDERATION OF EXCHANGE ACCOMMODATORS

Andrew G. Potter,
President

AGP/trm

Statement
# of the
International Council of Shopping Centers

Submitted by

Steven J. Guttman

to the
Subcommittee on Miscellaneous Revenue Issues
of the
House Ways and Means Committee

Regarding A
Hearing on Miscellaneous Revenue Issues
(Including A Proposed Change in the Like-Kind Exchange Rule)

September 21, 1993

I. International Council of Shopping Centers

My name is Steven J. Guttman and I am chairman of ICSC's Task Force on Taxes and President of Federal Realty Investment Trust in Bethesda, Maryland. I am submitting this statement on behalf of the International Council of Shopping Centers (ICSC). ICSC is the trade association representing the shopping center industry. ICSC's over 24,000 members in the U.S., Canada and over 40 other countries include shopping center owners, developers, managers, retailers, and other industry professionals. ICSC members are those individuals who are engaged in the day-to-day activities of designing, planning constructing, managing, financing, developing, leasing, and owning shopping centers and their retail stores.

There are nearly 38,000 shopping centers nationwide -- a 5-fold increase since 1964. As part of the real estate industry, shopping centers generated over $750 billion sales in 1992 -- equal to over 56% of non-automotive retailing in the U.S.

Since World War II, real estate has helped lead the economy out of eight recessions. This is from an industry accounting for 20% of the nation's GDP and employing nearly 10 million citizens.

The Government Relations Office of ICSC is located at 1199 N. Fairfax Street, Alexandria, Virginia 22314, (703) 549-7404, and ICSC is headquartered at 665 Fifth Avenue, 11th floor, New York, New York, (212) 421-8181.

II. Summary of ICSC Position

ICSC opposes replacing the "like-kind exchange" standard in IRC § 1031 with the "similar or related in service or use standard" because:

1. the current like-kind exchange rule is long-standing, fair, not subject to abuse, and beneficial to the economy.
2. such action would:
    a. significantly narrow the types of exchanges that would qualify for exchange and produce unfair results;
    b. not produce the expected revenue because many exchanges that would have gone forward tax-free will not occur if taxable, and the revenues currently realized in connection with such tax-free exchanges (boot and related taxable sales) will not be collected;
    c. unfairly result in the taxation of phantom income;
    d. have a negative impact on activity in the depressed real estate market and on economic activity in general; and
    e. increase the administrative burdens on the IRS and litigation in the courts.

III. Statement

A. Present Law

Present law (IRC § 1031) provides that no gain or loss is recognized if property held for use in a taxpayer's trade or business (or property held for investment purposes) is exchanged solely for property of a like-kind that also will be held for business (or investment) purposes. Deferred exchanges may occur, subject to limitations, provided the exchanged property be designated within 45 days and the exchange is completed within 180 days following the date of the original transfer.

In general, any kind of real estate is treated as of like-kind with other real estate, i.e., unimproved for improved real estate.

The like-kind standard contrasts with the standard under the Code provision (IRC § 1033) providing for nonrecognition of gain upon certain involuntary conversions of property (destruction, theft, seizure or condemnation). Other than upon a condemnation of real estate (where the like-kind standard applies), this section allows for nonrecognition of gain only if a taxpayer acquires replacement property that is "similar or related in service or use" to the involuntarily converted property. This standard is much narrower than the like-kind standard, i.e., unimproved and improved real estate generally are not considered "similar or related in service or use."

B. Current Proposal

Included in the miscellaneous revenue-raising proposals announced by the Subcommittee to be the subject of its September 21, 1993 Hearing is a proposal to amend the like-kind exchange rules "to require that the Code section 1031 property received must be 'similar or related in service or use' to the property exchanged, except in the case of condemnations "("Current Proposal").

C. Revenue Reconciliation Act of 1989

This proposal is similar to a provision passed by the House Ways and Means Committee and the House as part of the Revenue Reconciliation Act of 1989 ("RRA 89"), except that the RRA 89 provision applied the "similar or related in service or use" standard in cases of a condemnation of real estate as well as in exchanges of property.

The Senate, and the conference on RRA 89, rejected this and several other House provisions restricting the use of like-kind exchanges of real estate, although RRA 89 did contain provisions requiring a two-year holding period after an exchange between related parties and prohibiting like-kind exchange treatment for exchanges involving foreign-owned and U.S.-owned property.

D. ICSC Position

ICSC opposed the replacement of the "like-kind exchange" standard by the "similar or related in service or use" standard as included by the House in RRA 89, and opposes the Current Proposal for a similar change under consideration by the Subcommittee for a number of reasons.

1. The like-kind exchange rule is long-standing, fair, not subject to abuse, and beneficial to the economy.

The like-kind exchange rule has been in effect since 1924, and is based on the rationale that it is unfair to impose current tax liability on taxpayers exchanging like-kind property since they have not altered the nature, type or level of their investment or changed their economic position. In addition, since a like-kind exchange is exactly that, there is no cash generated to pay a current tax.

The like-kind standard refers to the nature or character of the property involved, not to its grade or quality. Thus, since improvements on real estate relate to its grade or quality and not its character as real estate, unimproved real property may qualify as like-kind to improved property.

The like-kind exchange rule has worked well for almost seventy years, contains a number of safeguards, and has not been subject to abuse.

The rule has been beneficial to the economy in facilitating all manner and kind of productive exchanges of real property that have "unlocked" real property and allowed for its improved productive use in instances that would not have occurred without its existence.

This is especially so regarding distressed property where the risks are great. Unfortunately the real estate market still must absorb weak properties from the RTC and other institutions and owners, and the ability to make like-kind exchanges provides an important technique to facilitate these transactions. A common transaction is where Developer A exchanges a healthy property for a distressed property owned by Institution B. A believes he can increase the value of the distressed property and because of his skills, experience, and willingness to risk his capital and time in improving the property he is in a better position to do so than the current owner. B then sells the healthy property acquired from A to Investor C in a taxable transaction. C does not want the risks associated with turning around the distressed property, but welcomes the real estate value associated with the good property. This transaction would not occur without the tax-free exchange between A and B. A has no incentive to sell directly to C because of the taxes incurred and because the sale would reduce his real estate assets which constitute his business.

In addition, although there is no gain that is taxed when like-kind property is exchanged, many such transactions produce current tax liability and revenues for the Treasury because of taxable events related to the exchange. Thus, cash and other non-like kind property (boot) received in an exchange is subject to current taxation if such boot or other property exceeds the adjusted basis of the property transferred. Moreover, frequently there are taxable sales which occur before, and in anticipation of, what ultimately becomes a qualifying like-kind exchange.

2. The Current Proposal to substitute the "similar or related in services or use" standard for the "like-kind" standard should be rejected because:

(a) It would significantly narrow the types of exchanges that would qualify for exchange and produce unfair results.

The "similar or related in services or use" is a much narrower standard than the "like-kind" standard and has been interpreted under section 1033 to require that both the physical characteristics and the end uses of the exchanged properties are similar. Thus, this standard has been held to prohibit the following exchanges: unimproved land for improved land, bank offices for office building for tenants, and hotel for office building.

(b) It will not produce the revenue expected because many exchanges that would have gone forward tax free under the like-kind standard will not go forward if taxable, and in fact, it may result in a reduction in the current revenues realized in association with such exchanges (boot and taxable sales related to such transactions) because of the reduction in the number of such exchanges. On its own terms, it will not produce the excessively optimistic and unrealistic revenues projected for the similar provision in RRA 89 since the Current Provision, contrary to that provision, maintains the "like-kind" standard for condemned real estate, the event most likely to produce additional revenues because it is involuntary.

(c) It will unfairly result in the taxing of phantom income. Since in an exchange there is no cash received (unless there is boot, which is currently taxed), taxpayers will not receive funds to pay the taxes that will result from the Current Proposal. In addition, if a taxpayer borrows against the property to pay for the current tax liability, the interest on the borrowed amount is non-deductible. Finally, when the property is sold at a later date, gain is taxed.

(d) It will have a negative impact on activity in the currently depressed real estate market and on economic activity in general. Because the current proposal will slow down the transaction rate of exchanges and tend to freeze properties in the status quo, it will lead to the deterioration of real estate values because it will discourage the transfer of property by old owners to financially stronger and/or more efficient and entrepreneurial hands who will revitalize the property and improve its efficiency and value and, as a by-product, contribute to improvement, efficiency, and the greater good of the economy in general.

(e) It will increase the administrative burden on the IRS and on the courts, by putting at issue in a much larger number of cases the question of what properties qualify for a tax-free exchange. While this will no doubt inure to the benefit of lawyers, accountants, and complicate the lives of IRS administrators, and the courts, in no way can this be counted as a benefit to the economy.

3. Conclusion

ICSC believes that there is no reason for the adoption of the Current Proposal and many reasons for continuing the use of the like-kind standard. Therefore, ICSC urges that the Subcommittee reject the substitution of the "similar or related in service or use standard" for the "like-kind" standard in section 1031.

REAL ESTATE EXCHANGE, INC.

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September 7, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Select Revenue Measures Subcommittee
September 14, 1993 Hearing

Dear Ms. Mays:

I am writing to comment on the proposal to change the requirement for exchange of property under I.R.C. § 1031 from a like kind test to a similar or related in service or use test.

Although there are numerous classes of personal property and some obvious exceptions to any exchange treatment, real property has always been liberally treated with a test that allows any property which is held for productive use in a trade or business to be exchanged for any other real property so held.

Although it is tempting to think that real property ought to be restricted in some way, in reality such a test would be a nightmare to administer. Although it is obvious to say that a single family rental ought to be exchanged for another or a shopping center for another, many forms of property would be difficult to categorize. For instance, how would one treat an exchange of a farmhouse rental on a farm for several houses or for a farm without a farmhouse on it? Would it be necessary to allocate and balance equities? How would one treat an exchange of a shop with rented rooms upstairs for a shop without rentals?

Moving past the administrative issues, one might move to the economic implications of this change. Often property can only be put into the stream of commerce by an exchange. The owner of a property which is not being used to its full potential, such as a collapsing warehouse or bare land in a developing area, will often hold onto the property for fear of the taxes to be paid from the sale. Wal-Mart induced many owners to sell through exchanging.

Without the exchange, stores would not have been built. The Columbia Gorge Scenic Area has acquired a number of properties from landowners who have exchanged from the purchase by the government. They are not buying more forest: they buy rentals in town. It is not always possible, or even desirable, to induce an exchange for property which is to be similar or related in service or use. Even if an attempt is made, there will still be problems in determining that which qualifies and that which does not.

In addition, the average investor has great difficulty in understanding I.R.C. § 1031. My staff and I spend our lives on the phone talking to those who need to understand what needs to be done. Many potential exchanges never happen because of the fear of the unknown. Since every exchange represents commissions, title fees, attorneys fees, and other taxable costs of sale, a decrease in real estate transactions can have a real impact on the income of those who work in real estate. If there are more complex tests for qualification, many will choose not to exchange.

My letterhead discloses the bias I have in favor of ease in exchanging. I do believe that the benefits enjoyed by the ease in transfer of real property and the taxable income derived by the professionals working in this area are a benefit to the economy. It seems preferable that the requirements for exchanges not be limited. Please put my letter down as one opposing the proposal. I urge that this proposal be allowed to quietly expire.

Sincerely yours,

REAL ESTATE EXCHANGE, INC.

James C. Casterline
President

Security Trust Company

925 "B" Street, Fifth Floor, San Diego, California 92101

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(800) 445-5652
Fax (619) 544-0028

September 10, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Select Revenue Measures Subcommittee
September 14, 1993 Hearing

Dear Ms. Mays:

This letter is written in specific response to the proposal to amend I.R.C. Section 1031 to substitute a "similar or related in service or use" requirement for the current "like-kind" requirement to which is scheduled to be discussed at the above referenced hearing.

Security Trust Company has previously expressed its opposition to this proposal when the same was included in Section 11601 of the Revenue Reconciliation Act of 1989 (H.R. 3150) as passed by the House of Representatives on September 28, 1989. As you are aware, this proposal was eliminated from the Act ultimately as passed and later signed into law.

Security Trust Company continues to strenuously oppose this proposal. The proposed change would substantially alter I.R.C. 1031 and would detrimentally effect thousands of transactions involving commercial, residential, industrial and agricultural real estate. This could be especially devastating to the fragile real estate industry as it struggles toward an economic recovery.

The proposal would alter the longstanding requirements for a tax deferred exchange under I.R.C. 1031 by replacing the existing "like-kind" test with a "similar or related in service or use" test borrowed from I.R.C. 1033. The "like-kind" test has been relatively easy to administer and has resulted in few litigation issues. In short, the "like-kind" test has allowed taxpayers to plan their transactions with a high degree of certainty as to an ultimate result. The "similar or related in service or use" test under I.R.C. 1033, on the other hand, has presented an ongoing administrative difficulty and has resulted in a litany of contradictory, confusing and often arbitrary court decisions and rulings. As a result, the "similar or related in service or use" test has prevented taxpayers from being able to properly plan their transactions. In fact, I.R.C. 1033(g) specifically contains an alternative "like-kind" test for real property held for productive use in trade or business or for investment as an outgrowth of these problems.

In conclusion, the Security Trust categorically opposed the proposed amendment to I.R.C. 1031 and strongly urges its elimination from the Subcommittee's current and future agendas.

Very truly yours,

J. Paul Spring
President

JPS/cm

Testimony of ENVIRONCOL

House Ways and Means Select Revenue Measures Subcommittee
Hearing on Miscellaneous Revenue Measures
Thursday, September 23, 1993

Summary of Testimony

The testimony urges the subcommittee to give no further consideration to proposals to require capitalization or amortization of environmental cleanup costs. Instead, lawmakers concerned about IRS actions discouraging prompt environmental cleanups should reaffirm the long-standing tax policy permitting current deductions for such costs.

Prior to the IRS' recent release of two technical advice memorandums (TAMs) in this area, businesses in a wide range of industries long had been deducting without challenge most environmental remediation expenses as repair and maintenance costs. The novel positions adopted in the two TAMs have not been approved by high-level IRS officials.

It is a basic rule of tax policy that deductions should be matched to income. Since costs associated with environmental cleanups generally relate to income earned in earlier years, immediate deductions are appropriate. Most environmental cleanup projects do not make property more valuable for use in the taxpayer's business, increase the life of the property, or adapt the property to a different use. Rather, they aim to return property to its ordinarily efficient operating condition. Thus, costs incurred are properly treated as incidental repairs that are currently deductible under Section 162.

The most important reason for rejecting the approach taken in the TAMs is that it conflicts with Administration and Congressional environmental policy. Most companies that become aware of the need for environmental cleanups are inclined to initiate remediation projects as quickly as financially possible. Yet the IRS rulings would set up barriers against adoption of cleanup plans by delaying tax deductions until long after completion of the cleanup projects.

Membership of ENVIRONCOL

ENVIRONCOL is made up of representatives of the following corporations: The B.F. Goodrich Company; Engelhard Corporation; Intermet Corp; LTV; M.A. Hanna; Northville Industries Corp.; Owens Corning; Reynolds Metal; Square D Company; Thiokol; Ultramar; and West Point Pepperell.

This testimony was prepared on behalf of ENVIRONCOL by James C. Godbout, Diane Herndon, and Mary Frances Pearson, partners at the Ernst & Young accounting firm. The address is: 1200 19th Street, N.W.; Washington, D.C. 20036. The telephone number is: (202) 663-9500.

ENVIRONCOL is concerned about proposals to deny current tax deductions for environmental cleanup costs on grounds that such proposals are both contrary to sound tax policy and to the realization of important environmental goals. Rather than consider proposals to require that such costs be amortized over a period of years, ***we urge the subcommittee to communicate to the Treasury Department support for the long-standing treatment of such costs under which current-year deductions are permitted in most circumstances.***

An August 18 Select Revenue Measures Subcommittee press release (Press Release #10) announcing hearings on miscellaneous revenue measures describes:

> a proposal to clarify the treatment of environmental remediation costs by (1) specifying the types of such costs that may be capitalized, or alternatively, (2) requiring that all such costs be amortized over a uniform period of years.

The latter alternative, denying immediate deductions to businesses incurring environmental remediation costs, represents a striking departure from long-established tax policies rather than a mere "clarification" of the law. ***Changing the law in this way represents bad tax policy and even worse environmental policy.*** The former alternative invites unnecessary confusion. The simplest approach to determining the tax treatment of environmental remediation costs is to apply existing caselaw under Sections 162 and 263, which in most cases would permit immediate deductions.

Prior to the Internal Revenue Service's recent release of two technical advice memorandums (TAMs) in this area, ***businesses in a wide range of industries long had been deducting without challenge most environmental remediation expenses as repair and maintenance costs.*** Tax practitioner response to the surprise IRS rulings has been almost uniformly negative. These rulings are based on misinterpretations of decades of caselaw. As a result of these rulings, clarification of the law may be needed. However, the only sensible clarification is to prevent the IRS from moving forward with the novel theory articulated in the two TAMs.

The focus of this testimony will be the legal weaknesses of the TAMs, since the proposal under consideration at this hearing appears to have been prompted by issuance of these rulings. However, for purposes of congressional consideration of this issue, tax policy concerns may well be of secondary importance to environmental policy concerns. IRS should not follow the reasoning set forth in the TAMs because to do so would prompt unnecessary litigation, in which the tax agency is unlikely to be successful. However, Congress is of course free to rewrite the law if necessary to achieve policy goals. Fortunately, ***all that is needed to achieve the goal shared by the vast majority of lawmakers of encouraging environmental cleanup is to ensure that IRS does not irresponsibly change rules that have long been in place.***

It's worth stressing that ***the positions adopted in the two TAMs have not been approved by high-level IRS officials.*** IRS stresses that such rulings may not be cited as precedent and are meant to apply only to the taxpayers to which they are specifically directed. Since issuance of the TAMs, representatives of industries which would be harmed by the theories set forth in them have met with IRS and Treasury Department officials and filed dozens of analytical papers with the Treasury Department and the White House in an attempt to point out the errors in the legal reasoning set forth in the rulings. In response, Treasury and IRS officials have indicated that the policies articulated in the two TAMs are by no means set in stone, and that more formal guidance will be forthcoming shortly.

Of course, there are some environmental cleanup expenses for which the members of ENVIRONCOL would agree with IRS officials that immediate deductions are not appropriate. For example, an immediate deduction generally is not appropriate for the costs of purchasing capital equipment needed in connection with a cleanup. ***No one is questioning the long-established rule that expenses of a capital nature do not generate immediate deductions.***

All that members of ENVIRONCOL and other corporate taxpayers are arguing is that IRS should not make a dramatic change in long-accepted understandings of the tax law, in deference to TAMs that uses reasoning not accepted by many IRS officials. While top IRS officials have not approved the TAMs, the ruling has already caused administrative problems for corporate taxpayers. The issue of deductibility of environmental cleanup coats has been raised in audits by IRS field-office auditors who are unsure of how to proceed now that a ruling has been issued questioning long-accepted understandings of the law.

An indication on the part of lawmakers that IRS should not assume the powers of the legislature by changing established tax law in this area would be appropriate and helpful. However, if the motivation behind announcement of the proposal being considered at this hearing is a belief that there is a need for resolution of the conflict between the views expressed in the IRS rulings and those expressed by the many tax practitioners who have been critical of those rulings, the effort is probably premature. Top IRS officials have not yet decided on the position they will adopt in any formal guidance that might be tested in litigation. There certainly is widespread concern over the possible ramifications if IRS were to pursue the theories set forth in the TAMs. As of today, however, there is no conflict to resolve because IRS as an entity has not yet taken a position on the tax treatment of environmental cleanup costs.

From a legal standpoint, the position taken in the TAMs is weak. From a policy standpoint, it is incomprehensible. A long list of federal and state laws encourages prompt environmental cleanup by businesses. ***Most companies which become aware of the need for such cleanups are inclined to initiate remediation projects as quickly as financially possible.*** Yet the IRS rulings would set up barriers against adoption of such plans by delaying tax deductions until long after completion of the cleanup projects. If the tax law required capitalization of these expenses, Congress might well want to consider changing the law to permit current-year deductions. However, it is hard to imagine a rationale under which lawmakers would want to change a law permitting current-year deductions to one requiring capitalization.

Environmental cleanup is an expensive process. As businesses become aware of problems, they try to live up to their responsibilities to address them. But ***slow economic growth has left many firms with small financial reserves during a time in which competition with international competitors has been intensifying.*** In some cases, a variety of possible cleanup approaches are available to an employer, and the availability of a deduction might allow for financing of the more environmentally sound choice. The firms making up ENVIRONCOL are not asking for a tax incentive for fulfilling their cleanup responsibilities. However, they are asking that their right to take deductions for costs arising from such efforts at the time the expenses are incurred be reaffirmed.

It is a basic rule of tax policy that deductions should be matched to income. The Internal Revenue Code attempts to match expenditures to the period of income generation by permitting a current tax deduction for ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business. Conversely, expenditures that relate to income to be earned in a future period should be capitalized.

In most cases, costs associated with environmental cleanups relate to income earned in earlier years. For example, a taxpayer might by virtue of scientific advances learn of a need for soil remediation. Ideally, costs for the remediation would be deductible in the years in which the business activity producing the pollution took place. But since it is impossible for the taxpayer to perform the remediation before learning of the problem, the closest that the tax law can come to matching income and deductions is to allow a deduction in the year the cleanup expenses are incurred.

Such treatment is consistent with the requirement under Internal Revenue Code Section 446 that the computation of taxable income begin with reference to the taxpayer's books and records. ***For book purposes, cleanup costs are generally expensed.*** From the perspective of economic performance standards, current deduction of a fixed and determinable liability is appropriate in the year such costs are incurred.

The two Internal Revenue Code Sections central to determining the proper tax treatment of environmental remediation costs are Sections 162 and 263. Section 162 generally allows a current deduction for ordinary and necessary expenditures incurred in a trade or business. Section 263 generally requires capitalization of expenditures for new buildings or permanent improvements.

To qualify for deduction under Section 162, an expense must be ordinary and necessary. Payments need not be incurred frequently in order to qualify as "ordinary." Instead, in the words of the U.S. Supreme Court in the 1933 case of *Welch v. Helvering* (290 U.S. 111), an expense will be treated as ordinary "if we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of [responding to a situation]." In contrast, Section 263 requires capitalization of expenditures satisfying one of three conditions: (1) that it add value to the property; (2) that it substantially prolong the useful life of the property; or (3) that it adapt the property to a new or different use.

Most environmental cleanup projects do not make property more valuable for use in the taxpayer's business, increase the life of the property, or adapt the property to a different use. Rather, they aim to return property to its ordinarily efficient operating condition. Thus, costs incurred are properly treated as incidental repairs that are currently deductible under Section 162.

For example, consider soil remediation expenses. The condition of the land after it has been cleaned is the same as it was prior to the expenditure-prompting event (i.e., its contamination). In addition, such costs do not increase the taxpayer's ability to generate future income. Soil remediation costs are not incurred for the primary purpose of generating revenue from the property, they do not make the land or the taxpayer's business more productive, and they do not add to the production of income in the future.

The fact that expenditures may have been incurred as a result of compliance with government regulations should not result in a finding of added value. The U.S. Supreme Court held in a 1971 case (*Commissioner v. Lincoln Savings and Loan Association* [403 U.S. 345]) that compulsion, whether legal or economic, should have no bearing on the question of whether a payment is treated as a deductible expense or a capital expenditure. The absurdity of requiring capitalization of all payments made on account of compliance with government mandates can be readily perceived by considering how such a rule would affect the tax treatment of payment of a minimum wage to employees or providing soap for hand-washing by food service employees.

Some courts have applied a *plan of rehabilitation doctrine* requiring capitalization of expenditures made pursuant to an overall plan even though taken separately the expenditures might otherwise be deductible. However, this does not mean that existence of a systematic plan, of itself, requires capitalization. Rather, the doctrine is applied where one of the Section 263 factors is present or where some type of substantial capital improvement is made to a structure in a state of disrepair. The plan of rehabilitation doctrine is not applied where costs are more in the nature of maintenance activities necessary to maintain property in its originally intended condition, as is the case in most environmental cleanup projects.

The members of ENVIRONCOL urge the subcommittee to give no further consideration to proposals to require capitalization or amortization of environmental cleanup costs. Instead, lawmakers concerned about IRS actions discouraging prompt environmental cleanups should reaffirm the long-standing tax policy permitting current deductions for such costs.

TESTIMONY OF
INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION
BEFORE THE
HOUSE WAYS AND MEANS SELECT REVENUE MEASURES SUBCOMMITTEE
HEARING ON MISCELLANEOUS REVENUE MEASURES
THURSDAY, SEPTEMBER 23, 1993

The Independent Fuel Terminal Operators Association ("IFTOA")[1/] hereby submits comments on the proposal included in the Subcommittee's August 18 press release to "clarify the treatment of environmental remediation costs by (1) specifying the types of such costs that may be capitalized, or alternatively (2) requiring that all such costs be amortized over a uniform period of years." IFTOA is strongly opposed to the proposals as well as any plan to deny a deduction for remediation expenses. IFTOA objects to these proposals (the "Proposals") because they conflict with (1) sound tax policy, and (2) long-standing environmental policy.

1. The Proposals Are Contrary to Fundamental Tax Policy.

The Proposals are contrary to fundamental tax policy because they require capitalization of what are clearly current period expenses. Under fundamental, long-standing tax policy, expenditures must be capitalized if they will produce an effect on income beyond the close of the current taxable year, *i.e.*, if they increase the value of property, prolong its useful life, or adapt it to a new use. Further, if capital expenditures can be shown to have a fixed and determinable useful life, the capital expenditures may be recovered over their useful life. Conversely, if an expenditure does not have a benefit beyond the

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[1/] A list of members and a more detailed description of the Association is attached. (Attachment A).

close of the taxable year, is a deductible current period expense.

Expenses incurred to remediate the environment do not (1) increase the value of property, (2) prolong its life, nor (3) adapt it to a new use. Moreover, such costs that will remediate property such as soil or underground water are not part of a plan to improve or restore productive business assets. These costs return property to its state prior to contamination. Such costs do not create significant future benefit but simply remedy existing conditions caused by past operations. These expenses are not undertaken in order for the taxpayer to derive some benefit from them but rather are undertaken to cleanse the environment.

Most remediation expenses have no benefit to the taxpayer beyond the close of the taxable year. Indeed, most environmental remediation expenses arise with respect to prior year's earnings of the taxpayer or with respect property that is not owned or beneficially used by the taxpayer. An expenditure to clean-up land not owned by the taxpayer surely has no current benefit or future benefit to the taxpayer. Similarly, an expenditure to clean-up environmental damage incurred in the taxpayer's operations terminated 20 years before, or which was contaminated by a prior owner of the land, produces no current or future tax benefit for the taxpayer.

Clean-up expenses that relate to a condition that arose during past business operations should be closely matched with the income generated from those past business operations. The current deduction of environmental clean-up costs is consistent with this concept of matching income with expenses underlying the capitalization rules. Such expenses should not be capitalized under a theory that relates them to the future production of income. Hence, environmental expenses should be currently deductible. That conclusion is in keeping with good public and tax policy.

2. The Proposals Conflict With Long-Standing Environmental Policy

A long-standing and fundamental public policy of the United States is to protect and remediate the environment. This policy has been fostered by over 40 federal statutes plus an unknown number of additional state statutes intended to protect the environment. The Proposals conflict with this policy in that it would (1) discourage voluntary clean-ups, and (2) prolong or prevent clean-ups required by law.

The denial of current expense deductions for environmental remediation expenses will materially increase the costs of clean-up projects for most companies. It must be remembered that environmental clean-up work is generally not an economically productive investment. Such expenditures do not make the person incurring them more productive or competitive. Indeed, the converse may be true. By further burdening environmental remediation expenditures, the Proposals would make American industry less competitive and less able to create jobs.

The Proposals represent bad environmental policy for another reason. To the extent that private concerns are unable or unwilling to undertake or complete environmental remediation activities, it is likely that (1) the environmental damage will increase, and (2) when remediation does occur, the costs of such clean-up will be borne by government.

We believe that any fair reading of current tax law leads to the conclusion that most environmental remediation expenses are currently deductible. No Congress interested in the perpetuation of sound environmental policy and sound tax policy would impose capitalization treatment upon such remediation expenses.

Accordingly, we urge the Subcommittee to reject any limitation on the deductibility of environmental remediation expenses which are otherwise currently deductible under Internal Revenue Code Section 162.

We appreciate the opportunity to comment on these issues and would be pleased to provide the Subcommittee with any additional information that it may need.

Thank you.

MEMBERS

INDEPENDENT FUEL TERMINAL OPERATORS ASSOCIATION

Castle Oil Corporation
Harrison, New York

Catamount Petroleum Corporation
Chelsea, Massachusetts

Coastal Oil New York, Inc.
Hasbrouck Heights, New Jersey

Colonial Oil Industries, Inc.
Savannah, Georgia

DeBlois Oil Company
Providence, Rhode Island

Getty Petroleum Corp.
Jericho, New York

Global Petroleum Corp.
Waltham, Massachusetts

Gulf Oil-Cumberland Farms
Canton, Massachusetts

Meenan Oil Co., Inc.
Syosset, New York

Northeast Petroleum Division
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Northville Industries Corp.
Melville, New York

PETRO
Stamford, Connecticut

Quinoil Industries, Inc.
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C.H. Sprague & Son Company
Portsmouth, New Hampshire
Wilmington, North Carolina

Statia Terminals, Inc.
Miami, Florida

Steuart Petroleum Company
Piney Point, Maryland

Tosco Corporation
Riverhead, New York

Webber Tanks, Inc.
Bucksport, Maine

Wyatt, Inc.
New Haven, Connecticut

The 19 companies listed above own or control terminals capable of receiving ocean-going tankers. None is affiliated with a major integrated oil company. Members of the Association are independent marketers of home heating oil (No. 2 fuel), residual fuel oils (Nos. 4, 5 and 6 fuels), gasoline and other petroleum products.

They distribute more than 50% of the No. 2 fuel oil consumed in New England and nearly 25% of the No. 2 fuel oil consumed along the East Coast; and they distribute nearly 60% of the residual fuel oil burned by non-utility consumers in New England and nearly 50% on the East Coast.

The 19 companies own or control 70 deepwater terminals and 51 barge and/or pipeline terminals, with a total storage capacity of about 73 million barrels. Of the total, about 25 million barrels are for No. 2 fuel oil, about 25 million barrels for residual fuel oil, about 16 million barrels for gasoline and 7 million barrels for other products.

TESTIMONY OF DONALD F. STRAETZ

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New York State Electric & Gas Corp
Niagara Mohawk Power Corporation
Orange & Rockland Utilities, Inc
Rochester Gas & Electric Corporation
St. Lawrence Gas Co., Inc
Syracuse Suburban Gas Company, Inc.

The New York Gas Group (NYGAS), an association of twelve natural-gas distributors, strongly opposes proposals that would require capitalization of all environmental remediation costs. We believe that it would be a major mistake from the standpoint of both environmental and business policy to penalize and therefore discourage - through the imposition of higher taxes- desirable cleanup activities. NYGAS is particularly concerned because of the potential cleanup costs which would be required to address asbestos, polychlorinated biphenyl (PCB) and residual-by-products from historical manufactured gas plant sites.

Congress must provide clear policy guidance in light of recent IRS technical advice memorandums (TAMs) that treat removal and cleanup costs as capital expenditures. Any Congressional provisions should be consistent with general tax principles and not merely revenue raising provisions.

We feel that capitalization of environmental remediation costs is a violation of the "matching of income" concept, which provides that capitalization is appropriate where costs will provide a future benefit and income will flow from that benefit. As it relates to environmental costs, the deduction will be taken in the future against income that was earned in prior years. In fact, where the property has changed hands, under capitalization the current owner could be taking deductions in the future against income earned in the past by another party.

Current tax law and regulations set standards by which an expenditure is classified as a deductible business expense or as a capitalizable expenditure. These standards look to whether the expenditure:

a) increases the value of the property as compared to its value at some previous time; b) increases the productivity of the property, or c) significantly extends the useful life of the property beyond its originally expected life. Environmental remediation does not increase the value, useful life or productivity of the property but seeks to restore the property to a useful and non-hazardous condition.

There is precedent in both the tax code and case law supporting the deduction for expenditures of this nature. For instance, environmental remediation costs are very similar to those incurred in the mining industry which have been held to be deductible, such as soil removal and backfilling. In fact, in 1984 Congress enacted an exception under Section 468 permitting a deduction for mining and solid waste reclamation and closing costs which might otherwise have been required to be capitalized.

Even though the objective of these expenditures is to ensure a cleaner environment, it should be noted that there are no special tax credits or bonus allowances which are granted to taxpayers. On the contrary, expenditures for environmental remediation are treated the same as any other business expense, and should be held to the same capitalization standards.

NYGAS opposes any plan to require capitalization of environmental cleanup costs, as a matter of tax policy, economic policy, and of environmental policy. From a tax standpoint, an arbitrary capitalization rule would distort the accurate measurement of income by creating an asset that presumes to have a future economic benefit when in fact it is unlikely income will flow from that benefit. From an economic policy perspective, eliminating the current deduction for cleanup expenditures merely adds to the already high costs that U.S. firms must meet in order to compete in the global marketplace. And lastly, but certainly most important, a tax proposal that requires remediation costs to be capitalized would hinder government efforts to secure clean commercial and industrial sites by significantly increasing the costs of those cleanup efforts.

Written Comments
of the
AMERICAN BANKERS ASSOCIATION
submitted to the
SELECT REVENUE MEASURES SUBCOMMITTEE
U.S. House of Representatives
concerning
MISCELLANEOUS REVENUE ISSUES
September 23, 1993

The American Bankers Association ("ABA") hereby submits its written testimony concerning miscellaneous revenue raising proposals that are before the Select Revenue Measures Subcommittee, per the Press Releases #9 & 10. Several proposals being considered would have an impact on the business of banking. The American Bankers Association is the national trade and professional association for America's commercial banks, whose members include banks of all types and sizes -- money center, regional and community banks. Assets of ABA members constitute approximately ninety percent of the industry total.

On July 17, 1993 Lynda Kern, Chairperson of ABA's Taxation Committee testified before this subcommittee in support of four proposals, each of which involves modest revenue costs but which would facilitate banks' ability to support the economic recovery and expand the credit to small business, small municipalities and individuals. The issues pending before the subcommittee now pertain largely to revenue raising proposals necessary to offset the cost of the legislative changes considered in June. As this Subcommittee and the Committee on Ways & Means considers how it will proceed to put together this tax bill, the ABA offers some general observations.

Congress has recently passed the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66), including major tax increases on both individuals and businesses. While the ABA commends the Congress for the willingness to address the national budget deficit, we believe the Congress must also be attentive to the impact of substantial revenue increases in light of the current economic conditions. We believe it would be prudent for the committee to now focus on a relatively narrow tax bill that does not include major changes in the tax code which alter the way American business operates or which impose substantial additional revenue costs during the weak economic recovery. ABA would especially commend the consideration of issues contained in H.R. 13. In addition, we urge the Committee to consider legislation which will address the uncertainties concerning the tax treatment of hedging and related transactions in light of the U.S. Supreme Court decision in the case of Arkansas Best v. Commissioner. The language contained in the conference report to the reconciliation measure (H. Rpt. 103-213) asked the Administration how to best proceed to resolve this problem, and we believe legislative action will be necessary.

In light of these general observations, ABA would like to comment on several proposals pending before the Subcommittee, some which we believe would be appropriate for the next tax bill and several of which should be rejected.

OPPOSE:

- Current inclusion of "points" received by lenders
- Capitalization of a portion of advertising expenses
- Change the foreign tax credit to a deduction
- Elimination of the portfolio interest exception to the 30% withholding tax on interest paid to foreigners
- Deny the deduction for interest payable on corporate tax underpayments

SUPPORT:

- Permit nonbanks to utilize a presumption of worthlessness for charge-offs of bad debts

- Expand information reporting on debt forgiveness to all lenders

INCLUSION OF "POINTS" RECEIVED BY LENDERS

ABA opposes the proposal to require all mortgage lenders to include in income at the time of receipt, points paid in connection with mortgage lending transactions. The ABA urges the Committee to reject this proposal, because the underlying economic substance of the transaction supports taking the points into income over the life of the loan.

In effect, the points are a reduction in the issue price of the loan. Treasury and the IRS have recently adopted this position in Proposed Regulations 1.1273-2(j)(2) issued in December, 1992. It would be counterproductive to retrace that decision, just to reverse the result. The recently proposed regulations reflect a policy that points charged in connection with a loan operate to raise the yield on the investment without changing the cash flow, regardless of whether the points were paid by the borrower with separate funds, or financed by the lender.

CAPITALIZATION OF ADVERTISING EXPENSES

The ABA also opposes the proposal to capitalize a portion of advertising expenses, instead of deducting them currently. This would represent a major change to the tax code, in one of the principal areas of business expenses. This is an ordinary and necessary business expense which should not be capitalized merely for revenue considerations.

The proposal would be particularly disruptive in the highly competitive business of providing financial services, where consumers rely on advertising to better understand the various products and services offered. The availability of information makes the markets work more effectively. Increasing the cost of advertising would undercut the availability of information and impair banks' abilities to distinguish themselves from other financial services firms on the basis of price, rates or other services. As such, we think Congress should oppose the proposal as being anti-consumer.

CHANGE FOREIGN TAX CREDIT TO DEDUCTION

The proposal to change the foreign tax credit to a deduction would constitute a radical change in the tax code which would dramatically increase the cost for U.S. firms of doing business overseas. The foreign tax credit provisions of existing law are designed to prevent U.S. taxpayers from being taxed twice on their foreign income, once in the foreign country and once again in the U.S. The percentage limitation and separate baskets imposed under Section 904 already place a heavy burden on U.S. firms competing against foreign businesses in the international marketplace. The ABA opposes any further changes in the taxation of foreign source income which would increase the competitive disadvantage of U.S. banks and other firms overseas.

At a time when the U.S. is actively pursuing international agreements to expand the ability of U.S. firms to do business overseas, i.e. NAFTA and the Uruguay Round of GATT, Congress should be considering ways to eliminate unnecessary complexity in the law and to provide a tax system which will allow U.S. firms to compete in the international marketplace on an equal footing. The significance of a restrictive tax regime on international competition should not be underestimated. U.S. banks are currently held back in a competitive sense, by outdated banking laws and government regulations which limit the type and amount of financial products they can offer, and by more strict capital standards than those imposed on their counterparts in the major financial centers. The impact of these restrictions on U.S. banks can be measured by the clear decline of the competitiveness of U.S. banking worldwide. In 1973, eight of the world's 30 largest banks were U.S. banks, whereas today only one U.S. bank is in the top 30.

Tax costs, like regulatory and capital costs, similarly put U.S. firms at a serious disadvantage which results in lost jobs and income in the U.S. According to the LaFalce Task Force Report on International Competitiveness of U.S. Financial Institutions (October 1990), the possibility that U.S. banks won't maintain a significant presence in both domestic and international banking markets could have serious economic consequences for the U.S. companies seeking to borrow funds to maintain or expand their businesses.

We urge the committee to reject the proposal to change the foreign tax credit into a deduction because it would greatly impair the ability of U.S. firms to do business worldwide.

DEDUCTION FOR INTEREST PAID ON CORPORATE TAX DEFICIENCIES

In 1990, the Congress considered and finally rejected a Senate proposal to disallow the deduction of interest paid by corporations related to their tax deficiency. At that time it was well recognized that this was largely a budget gimmick inconsistent with fair tax administration. The corporate tax audit process is very complicated and time consuming. This is especially true in connection with audits of commercial banks where the amounts challenged by IRS agents arise over factual aspects of IRS coordinated issues within the banking industry. Bank taxpayers must take positions on their tax returns by claiming the deduction or forego the deduction altogether. Bank taxpayers should be not penalized by dramatically increasing the cost for disagreeing with the IRS with respect to highly factual issues.

The Ways & Means Committee is fully aware of the enormous complexity that exists in the tax code. The recently enacted reconciliation measure simplified one major issue for the business taxpayers, the amortization of purchased intangible assets. While this change will substantially reduce an area of future tax complexity for commercial banks, there are still many more tax audit issues which will involve long, drawn-out examinations and appeals, pre-litigation disputes, and in some cases tax litigation.

The taxpayer already has a built-in financial incentive to pay the tax based on the 3% disparity between the amount of interest IRS pays on refunds and the amount of interest taxpayers must pay on tax deficiencies. That governmental advantage should not be turned into sledge hammer by denying the deduction altogether for interest on corporate tax deficiencies. The ABA urges Congress to reject this proposal.

PORTFOLIO INTEREST EXCEPTION TO THE 30% WITHHOLDING TAX

The banking industry strongly opposes the imposition of the 30% withholding tax on the portfolio interest earned by foreigners because it would directly increase the borrowing costs for both government and private U.S. borrowers. The Treasury Department has again voiced its opposition to this short-sighted policy, consistent with its position advocated since 1984, when the portfolio interest exception was adopted. Imposing the tax will greatly diminish foreign investment in debt instruments issued by US borrowers, thereby increasing their costs. Moreover, reducing the pool of foreign investors will frustrate legitimate deficit reduction efforts already undertaken to reduce the cost of government and private borrowing.

The premise on which the 1984 repeal was based is even more sound today because the amount of the U.S. debt marketed outside the country has actually increased. In fact, the mere presence of this provision on the revenue raiser list has already raised serious concerns in the eyes of foreign investors in U.S. debt to adopt the provision would create a mass exodus of foreign investors.

This provision can also affect American consumers. U.S. banks currently issue debt to foreigners and use the proceeds to make domestic mortgage loans. If this proposal were to be adopted, there would be less funds available in the U.S. to provide to U.S. customers at favorable rates. ABA joins the Treasury Department in its strong opposition to this proposal.

NONBANK CHARGE-OFFS

The ABA supports the proposed change to permit nonbank lending institutions to have a presumption of worthlessness for charging-off a bad debt, consistent with the regulatory criteria applicable to depository institutions. The ABA favors this proposal because we believe that "functional taxation" is appropriate for competitors, i.e., all financial services providers should be taxed on the same basis, with the same rules, if they perform the same functions.

The original charge-off rule was adopted for banks and premised on a system that has been proven to work over time. A conclusive presumption arises from a determination of the regulatory agency that a debt is worthless. That presumption is equally valid for nonbank lending institutions as it is for banks.

INFORMATION REPORTING ON DEBT FORGIVENESS FOR ALL LENDERS

The ABA supports the proposal to broaden the definition of those entities that are required to file information returns on forgiven debts, to all companies that are in the business of making or acquiring loans. This proposal is again consistent with the ABA's advocacy of functional taxation, mentioned above, where all entities that engage in the similar transactions should be treated the same. We see no reason why some in the business of making and acquiring loans, such as finance companies and insurance companies, should be exempt from the requirement to file information returns with the IRS when debt is forgiven. Their customers are subject to the same tax rules on cancellation of indebtedness income that apply to bank customers, and those customers should be subject to the same level of IRS audit scrutiny. The compliance issues for non-bank lenders are the same as they are for banks. The current narrow provision actually detracts from legitimate IRS enforcement efforts.

Despite the fact that this is proposal is consistent with the Treasury Department's stated principals and goals (included in their testimony delivered on September 21), of deficit reduction, equitable treatment of taxpayers, simplification and improved compliance, they have nevertheless indicated, with little discussion, that they do not support this provision. We strongly disagree and believe that all in the business of making and acquiring loans, which subsequently forgive indebtedness, should be required to send information returns to the IRS. To arrive at any other result leads to competitive imbalance and tends to favor one industry over another in reducing their regulatory burden. Moreover, given the substantial market share of commercial loans held by non-bank lenders, the revenue gain from this proposal is worth the effort.

* * *

If you have any questions about these written comments, please contact Henry Ruempler (202-663-5317) or Angelynn Hall (202-663-5322) at the ABA in Washington, D.C.

Comments of the American Electronics Association
Submitted to the House Ways & Means
Select Revenue Measures Subcommittee

U.S. House of Representatives

September 21, 1993

Mr. Chairman: The American Electronics Association welcomes the opportunity to present comments on several miscellaneous revenue measures before your committee. Many of these proposals have appeared in the past and were vigorously opposed by the AEA and many other industry associations. So it should not surprise you that we oppose this 1993 version and will continue to oppose future attempts to enact these proposals.

There are three specific miscellaneous revenue proposals before your subcommittee which are of particular concern to the high technology industry. These proposals would modify the export source rule; replace the foreign tax credit with a deduction for foreign taxes paid; and, disallow stock options as a qualifying expense for purposes of the Research Tax Credit. The AEA believes these three proposals would hurt the industry's competitive position and strongly opposes their enactment.

In addition to the specific proposals enumerated above, we also are discouraged to note the many proposals to limit or deny certain business deductions permitted under current law. The AEA along with many other industry associations, continues to oppose additional limitations on tax deductions for ordinary and necessary business expenditures.

The AEA is the nation's largest electronics association, representing more than 3,000 companies in the electronics and information technology industry. The voice of the electronics industry for more than 50 years, AEA has an active grassroots network of 17 councils in all key U.S. high technology centers, as well as offices in Tokyo and Brussels. AEA member companies are al based in the united States and span the breadth of the electronics industry, from silicon to software to all levels of computers and systems integration. The giants of the electronics industry are AEA members. At the same time, almost 70 percent of AEA members are small to medium-sized companies with less than 250 employees and less than $50 million in annual sales. The issues before us today are of concern to all of our member companies.

I. INTERNATIONAL

The international tax provisions in the Internal Revenue Code are more complicated than ever before. These provisions in combination with the related IRS regulations have created an environment of such complexity and uncertainty that many corporate taxpayers, regardless of their technical resources, do not know how to completely and accurately comply with rules they cannot understand. The compliance burden imposed by these rules will overwhelm many small and medium-sized corporations. Continued piecemeal attempts to change isolated tax rules will serve to increase complexity and uncertainty in this area.

EXPORT SOURCE RULE MODIFICATIONS

The AEA is a member of the Export Source Rule Coalition, and agrees with their comments. The AEA is submitting additional comments, however, to emphasize the importance of the issue to the electronics industry, particularly as it affects small and medium sized companies.

The export source rule is not just a provision which helps the large U.S. companies. Rather, to the extent small companies are exporting, their tax burdens are also reduced. Indeed, the Fortune Magazine report on exports states that most of the 6 percent increase in exports this year was attributable to small and medium sized companies.[1] As the Export Source Rule Coalition internal survey found, smaller companies that export tend to export a larger proportion of their total sales than larger companies.[2] As a result, a change in the export source rule will have a more severe effect on small companies than on the typical large multinational company because small companies are more oriented towards exports than the large companies.

Given small companies dependence on the future success of U.S. exports, we urge you not to adopt any cut back on one of the few, GATT legal provisions that works as an export incentive remaining in our tax code.

The proposal imposes a limit on the amount of the manufacturing and sales income of the U.S. exporter that can be attributable to foreign sales activities where the inventory goods are sold by the taxpayer to a foreign related person. Under the proposal the amount attributable to manufacturing activities cannot be less than the portion of the combined income of the taxpayer and related person attributable to the inventory property that would have been apportioned to manufacturing activities under the current law rules had both parties been treated as one U.S. taxpayer.

The effect of the proposal will be to substantially reduce the foreign source income generated by export sales and increase U.S. companies cost to export products outside the U.S. The proposal undermines the most effective U.S. tax incentive for exports. As such, if enacted, it can only have an adverse effect on the future growth of exports.

One of the goals of the new administration is to support the ever increasing level of U.S. exports. This goal appears to have been embraced due largely to the effect of exports on unemployment. Any export cut back will reduce these jobs. Congress should be pursuing tax strategies that encourage companies to manufacture in the U.S., rather than cutting back the few export incentives that remain for U.S. manufacturers.

Moreover, the proposal will disproportionately affect similarly situated taxpayers. Particularly affected will be those companies with greater foreign marketing efforts. U.S. electronics companies must continually increase their marketing efforts overseas to sell effectively outside the United States. U.S. brand names have less value than a local manufacturer's name in these markets without these marketing efforts. To penalize those firms which are taking the right steps to increase exports so as to support more U.S. manufacturing jobs is clearly counter-productive to the creation of U.S. jobs.

The proposal will make the export source rule extremely difficult to administer. The proposal would require extensive regulations that would, for example, have to state how a taxpayer would determine the portion of a foreign affiliate's income that is attributable to the exported product where the foreign affiliate incorporates the U.S. manufacturer's components into another product which is sold to third party customers. This problem is particularly acute in the electronics industry where global sourcing is becoming more and more common.

Finally, the proposal's potential application to FSC sales is completely inappropriate. The FSC regime has not been challenged under the rigorous GATT legal constraints; it should not be further hindered by the U.S. efforts to raise revenue.

In sum, the proposed export source rule change is a bad policy proposal that will increase administrative costs and decrease exports, jobs and future economic growth. This impact will be felt acutely by small and medium sized electronics firms. The AEA strongly urges that this proposal be dropped.

PROPOSED DEDUCTION FOR FOREIGN TAXES PAID

One of the proposals under consideration is to replace the foreign tax credit with a deduction for foreign taxes paid. This proposal goes back to the Burke-Hartke legislation which was intended to preclude foreign investment by U.S. firms. By allowing only a deduction for foreign taxes paid, U.S. law would impose a second layer of taxes on income which has already been taxed abroad, raising the effective rate of tax at the corporate level to prohibitive levels. For example, in the case of a foreign country with an effective 52% tax rate, the U.S. company would pay 35% (not counting state taxes) on the remaining 48% of after tax earnings, for an effective total rate of 68.80%

Fortune Magazine, p. 130 (June 14, 1993).

Gary C. Hufbauer and Arthur Hammond-Tooke, U.S. Export Competitiveness and Source-of-Income Rules (Jan. 1988).

By imposing prohibitive tax rates on overseas operations, the proponents of this legislation hope to increase U.S. investment and jobs. The opposite would in fact result. U.S. exports have supplied nearly all the growth in the U.S. economy in recent years. Most of those exports go to the overseas affiliates of U.S. firms. It is those firms which invest the most overseas which have the highest rate of growth in exports.

Preventing overseas investment by U.S. firms would result in a loss of export markets, and a loss of U.S. jobs. The U.S. electronics industry is highly export oriented and would be especially hard-hit. A further effect would be felt when U.S. firms dropped out of foreign markets. Access to leading edge technology depends on maintaining a presence in all major markets. Failure to do so would eventually mean a loss of even domestic markets to foreign competitors.

Instead of eliminating the foreign tax credit, it should be strengthened. For example, in recent years two proposals have been advanced which would greatly improve the credit at little or no revenue cost.

1) extend the credit below the third tier of foreign subsidiaries, and

2) conform the carryover period for unused credits to that of other carryovers - 15 years

Extending the credit down the tiers would cost little since companies presently do not organize in a way that would create a double tax. Allowing more organizational flexibility would increase business efficiency.

Similarly, conforming the carryover period would further reduce the risk of double taxation for international operations that the credit is intended to provide.

II. DOMESTIC

DISALLOWANCE OF STOCK OPTIONS FOR PURPOSES OF THE R&D CREDIT

The third proposal on which the AEA is submitting testimony is a proposal to disallow stock options as a qualifying expense for purposes of the research tax credit. Mechanically this is accomplished by providing that the compensatory element in stock options exercised by employees performing qualifying research and development work, although compensation for all other purposes of the Internal Revenue Code, will not constitute compensation for purposes of calculating the research and development credit.

We believe this proposed change is a direct result of recent litigation lost by the IRS on this very issue. Good tax policy does not arise from Congress legislatively reversing IRS litigation positions which are clearly erroneous under the law. Instead, tax law changes should arise from clearly thought out policy changes. From a policy perspective, this proposed change is simply a poor idea.

This proposal singles out companies falling into either of two categories: companies which are research intensive and companies relying on stock options as a significant element in compensating, incenting and retaining innovative employees. A preponderance of our member companies meet both descriptions, probably to a greater degree than any other industry.

One characteristic of our industry is its relatively large stake in research and development. With our industrial base more and more dependent on new technology, industry must expand its investment in innovation. This is a high risk process, however, and its outcomes are hard to predict.

Congress has, for well thought out policy reasons, sought to encourage risks associated with research conducted in the U.S. through a tax credit on incremental research expenditures. Since the inception of the research credit in 1981, "wages" have been a credit eligible expenditure. For this purpose Congress chose to define "wages" by using the definition in the Internal Revenue Code section 3401(a), defining wages subject to withholding. We are unaware of any good tax policy reasons for changing this definition of wages.

We believe, in fact, that good tax policy dictates that the incentive provided by the research credit should not be reduced by narrowing the tax definition of "wages" under current laws. The electronics industry is characterized by job creating growth companies which emphasize entrepreneurship and risk-taking. For start up companies with few resources, stock options often present the only viable way to attract and keep talented engineering personnel. Creating obstacles and disincentives to the grant of options in this context seems short-sighted at best. At a time when research is critical to our nation's future success in competing globally, the research credit should not be reduced and the use of stock options should not be discouraged.

OTHER ITEMS

Our comments have focused in on a few items which are critical to the electronics industry. We also feel compelled to comment on several proposals of broader policy concern which other groups will be addressing in more detail. One proposal would require that a portion of advertising expenses be capitalized and amortized. A second proposal would deny a corporate deduction for interest paid to the IRS on tax deficiencies. During the past eight years, Congress has continued to increase limitations on tax deductions for ordinary and necessary business expenses incurred by U.S. companies. The list now includes meals and entertainment, lobbying costs, club dues and certain executive compensation. The proposals above serve to further erode the measurement of a company's business income in an effort to generate revenue. We oppose any additional limitations on business deductions.

TESTIMONY OF AMERICAN FOREST AND PAPER ASSOCIATION

The American Forest and Paper Association (AF&PA) is the national trade association of the forest products industry representing producers of paper, pulp, paperboard and wood products, as well as the growers and harvesters of this nation's forest resources. The industry has over $200 billion in total shipments, 1.4 million workers, and operates in every state in the union. Forest products represent more than seven percent of U.S. manufacturing output, and the industry is among the top ten employers in 46 states with an annual payroll of $44 billion.

The forest products industry is one of the nation's most globally competitive industries. In 1992 exports totalled approximately $16 billion, and there was a positive balance of trade in both paper and wood products. However, the ability to increase or even maintain current levels of exports could be jeopardized if the tax burden on U.S. firms attempting to compete with foreign companies is increased.

The continuing negative impact of the Alternative Minimum Tax on capital intensive industries which did not significantly benefit from the 1993 AMT provisions, the U.S. tax treatment of foreign source income, and the recent increase in the corporate tax rate have put U.S. businesses at a serious competitive disadvantage by preventing American companies from fully exploiting situations in which American industries enjoyed a cost of production advantage. Imposing more tax penalties and adding additional complexity to the tax code would further impede the ability of American business to compete in world markets.

We share Congress' desire to restore strong and sustained economic growth to the American economy, but many of the proposals under consideration by this committee will further reduce the cash flow of America's corporations and inhibit their ability to invest in future productivity and growth. We fully recognize the responsibility of your Subcommittee to review potential tax raising provisions to be used as the funding source for future legislation, but we believe that it is poor tax policy to impede capital investment in plant and equipment and other business assets, which are necessary to create new jobs and ensure economic growth. Because of the tax policy implications of these proposals, we feel compelled to comment on the provisions listed below.

Under separate cover, we are submitting our detailed objections to the proposal to add methyl bromide to the list of ozone depleting chemicals under Code Sec. 4682.

Specific Concerns

Compliance Provisions

Several proposals would add another level of cost and complexity to existing complex recordkeeping requirements. Further limitations on the deductibility of ordinary and necessary business expenses, including advertising deductions and interest expense on tax underpayments, would amount to a tax penalty against businesses which are already paying their fair share of corporate taxes, including a higher rate of interest on underpayments than the IRS pays on refunds. Such limitations would contribute to a further erosion of the tax system based on income.

Foreign Tax Provisions

Proposals to change the foreign tax credit to a deduction, and to modify the sourcing rules, would unfairly impose additional tax burdens on U. S. firms attempting to compete with foreign companies. Retention of an effective, undiluted foreign tax credit mechanism is fundamental to the continued growth of U.S. international trade and overseas investment. The foreign tax credit is neither an incentive nor a loophole, but merely protects United States businesses from the danger of multiple taxation of foreign income. Federal tax policies which compromise the ability of U.S. business to compete in foreign markets also adversely affect U.S. based employment and economic growth.

Alternative Minimum Tax Proposals

Although our industry would not be directly affected by these proposals, we are very disappointed with the thrust of several proposed changes which point to additional penalties and impediments to job creating investments. Any changes in the corporate Alternative Minimum Tax (AMT) should be designed to speed our economic recovery, rather than penalize specific segments of the business community by levying additional costs on capital investment necessary to revitalize our industrial base.

Like-Kind Exchange Provisions

The like-kind exchange provisions of Code Sec. 1031 are very important to resource based industries like the forest products industry, especially for realigning ownerships for management efficiency. The rules for tax-free exchanges were restricted significantly in 1984, with IRS having only completed the new regulatory framework for exchanges in 1991. These revisions have eliminated the potential for any abusive situations and, consequently, no further limitations on tax-free exchanges are necessary.

Environmental Remediation Expenditures

Of particular concern and significance to the forest products industry are proposals dealing with the tax treatment of environmental remediation expenditures. This industry has made, and is continuing to make, significant contributions to environmental protection. The industry has invested over $10 billion to ensure environmental protection and improvement and is committed to substantial expenditures for cleaning up property with environmental contamination. Revenue-raising objectives appear to be in conflict with tax law principles, counter-productive for environmental policy, and anti-competitive for U.S. manufacturers. Businesses have, quite appropriately, normally considered remediation expenditures as ordinary and necessary business expenses, and the proper role of the U.S. government should be supportive of this tax treatment both from the standpoint of environmental policy and international competitiveness.

We agree with the Administration's position on the proposal to disallow deductions for compensatory damages under certain environmental laws. Current law distinction between deductible compensatory payments and nondeductible fines and penalties should be maintained with respect to payments under environmental laws. Denying deductions for ordinary and necessary cleanup expenditures and compensatory payments would only serve as a disincentive to future cleanup efforts and settlement payments.

We appreciate this opportunity to submit our views on the proposals being considered by your Subcommittee.

STATEMENT OF THE
AMERICAN GAS ASSOCIATION
BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
ON
MISCELLANEOUS REVENUE-RAISING PROPOSALS

September 23, 1993

I. Introduction and Summary

The American Gas Association (A.G.A.) is a national trade association comprising some 250 natural gas distribution and transmission companies throughout the United States. Collectively, 90 percent of the gas consumers in this country are served by A.G.A.'s members.

A.G.A. member companies are subject to a variety of environmental statutes and compliance regulations, and are interested in the proper tax treatment of environmental remediation costs. A portion of the annual dues paid by these member companies to A.G.A. are expended on lobbying activities. All our members incur expenses for business meals and entertainment expenses. Many companies provide employees bonuses.

Thus, A.G.A. and its member companies have a direct and substantial interest in this hearing pertaining to revenue raising measures to: 1) clarify the treatment of environmental remediation costs by i) specifying the types of costs that must be capitalized, or, alternatively, requiring that all such costs be amortized over a uniform period of years; 2) disallow compensatory damages under certain environmental laws; 3) impose a 30 percent excise tax on lobbying expenditures for tax-exempt organizations; 4) require written substantiation of all business meals and entertainment expenses or those in excess of $10; and, 5) increase the rate of withholding on employee bonuses from 28 percent to 36 percent.

A.G.A. submits the following statement for due consideration by the Subcommittee. A.G.A. believes that if Congress proposes to legislate in the area of environmental remediation costs that it should provide clear guidance to assist taxpayers in the myriad of different factual patterns and tax principles related to the expensing of costs for repairs versus the capitalizing of expenditures for capital improvements. Clear policy guidance is needed from Congress in light of the decisions reached by the Internal Revenue Service (IRS or Service) in two technical advice memorandums (TAMs)[1] that treat certain costs for asbestos and polychlorinated biphenyl (PCB) removal and cleanup as capital expenditures. These TAMs are inconsistent with longstanding tax principles governing the distinction between repairs and maintenance costs and expenditures that must be capitalized. They will create a chilling effect on many businesses considering the voluntary removal of asbestos and PCB.

A.G.A. strongly opposes proposals that require capitalization of all environmental remediation costs. Congress should recognize that overcapitalization of environmental cleanup costs would serve to deter environmental remediation. To the extent possible, the Congress, consistent with general tax principles, should seek to adopt guidelines that encourage national environmental objectives.

A.G.A. also opposes legislation to deny deductions for compensatory damages paid under environmental laws. Such expenses, we believe, are a cost of doing business.

A.G.A. opposes proposals to restrict the ability of trade associations to lobby their federal and state governments. A.G.A. believes an excise tax limits the trade association's ability to engage in free speech with governing officials. We oppose a measure to require documentation for business meals and entertainment expenses as well as a proposal to increase withholding on bonuses.

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[1] TAM 9315004 (December 17, 1992) (Polychlorinated biphenyl cleanup, "PCB TAM"); TAM 9240004 (June 19, 1992) (asbestos removal and replacement, "asbestos TAM").

II. Treatment of Environmental Remediation Costs

A. Tax Policy Should Encourage Environmental Remediation

A.G.A. opposes proposals to treat environmental cleanup and other remediation costs as capital expenditures under Code §263. A.G.A. supports initiatives clarifying that such costs are properly deductible as "ordinary and necessary business expenses" under Code §162. If these costs are viewed in terms of tax principles applicable to repairs, they would generally be found not to materially add to the value of property nor appreciably prolong its life.

A national policy goal is to improve and preserve the environment. There are nearly 40 federal statutes enacted for preserving and cleaning the environment. For example, the "Comprehensive Environmental Response, Compensation, and Liability Act of 1980" (CERCLA),[2] is perhaps the most important statute enacted for the purpose of environmental remediation. That law establishes a program for appropriate environmental response action to protect public health and the environment from the dangers posed by inactive hazardous waste sites. In addition to federal statutes, virtually every state has enacted environmental legislation.

Tax policy should encourage the national policy goal of protecting the environment. Congress should not thwart environmental policies unless compelled to do so by sound tax principles. We do not believe longstanding tax principles that distinguish deductible expenses from those required to be capitalized provide a sound basis for Congress to require capitalization of environmental remediation costs. If Congress were to assess the effect that an overcapitalization approach could have upon environmental policy, it would find that such policy would deter efforts to clean the environment.

Broad scale non-deductibility of expenses incurred for environmental cleanups would adversely affect the taxpayer's cash flow and working capital. If the corporate taxpayer is required to capitalize, for example, expenses incurred for asbestos removal, the company's cash liabilities would be increased. Taxpayers would be less inclined to undertake such remediation projects.

Capitalization would make it economically infeasible for many businesses to begin remediation and could penalize those that proceed with it. Environmental cleanup costs oftentimes far exceed any possible value that is produced as a result of the cleanup. Without the deduction, taxpayers could not undertake the project. To take a common case, a soil remediation project for a 20 acre site could easily cost over $1 million while increasing the appraised value by less than $10,000. Thus, taxpayers will have a strong financial incentive to delay making expenditures as long as possible if they are forced to capitalize environmental cleanup costs that do not produce significant value. Clearly, this would frustrate efforts for achieving national environmental objectives of encouraging remediation.

The Service has historically taken tax positions that do not interfere with broadly-defined, non-tax public policy goals. The IRS has ruled, based on non-tax public policy grounds, that a private school that has racially discriminatory policies cannot be a "charity" under Code §501(c)(3).[3] It has also ruled that payments made to promote the general welfare under legislatively mandated social programs (i.e., home rehabilitation grants received by low-income households)[4] are excludable from gross income. We believe Congress should set forth sound tax policies that do not impede environmental goals.

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[2] Comprehensive Environmental Response, Compensation, and Liability Act of 1980, 42 U.S.C. §§9601-9675.

[3] See Rev. Rul. 71-447, 1971 C.B. 230.

B. Environmental Remediation Costs Should Be Determined Under The Tax Principles of Code §§ 162 and 263

1. Code §162(a)

A.G.A. supports policies to treat environmental cleanup and remediation costs under tax principles used to allow deductions for repairs under Code § 162(a), and the regulations and case law supporting that section. According to §162(a), a taxpayer may deduct all ordinary and necessary expenses, including those for repairs, paid or incurred during the taxable year for carrying on a trade or business. Treasury Regulation §1.162-4 provides that repair expenses may be deducted as "ordinary and necessary business expenses" if they neither materially add to the value of the property nor appreciably prolong its life, but simply keep it in a safe and efficient operating condition.

A.G.A. supports guidelines clarifying that environmental costs are properly deductible under Code §162(a), even if they are non-recurring and cleanup occurs over a number of years. An expenditure does not have to be habitual or repetitive in nature to qualify as a deductible repair expense. Some courts have held that repairs can be unique to the taxpayer's business and still be considered to be ordinary. For example, in American Bemberg Corp. v. Commissioner, 10 T.C. 361 (1948), nonacq., 1948-2 C.B.5, aff'd, 177 F.2d 200 (6th Cir. 1949), the Court held that expenditures to prevent sub-soil cave-ins threatening the destruction of a manufacturing plant were deductible. The Court recognized that the work required was not a type used before or likely to be used again.

2. Code §263

The Code provides that no deduction is allowed for amounts paid for new buildings, permanent improvements or betterments made to increase the value of any property. According to Code §263, these expenses must be capitalized and recovered through depreciation. Treasury Regulations §§1.263(a)-1(a) and (b) provide that an expenditure must be capitalized if it: 1) substantially prolongs the life of the property; 2) materially adds to the value of the property; or, 3) adapts the property to a new or different use.

In some cases, an expense that would otherwise be treated as a repair might be considered a capital expense under the "plan of rehabilitation doctrine." A.G.A. believes that, in most cases, environmental cleanup costs should not be characterized as the creation of a new capital asset to warrant application of that tax principle. The rehabilitation doctrine requires otherwise deductible repair expenses to be capitalized because such expenses are a part of or are closely related to a capital improvement. In Moss v. Commissioner, 831 F. 2d 833, 835 (9th Cir. 1987), the Court considered a series of capital expenditures involving re-painting and re-papering of remodeled areas to be deductible and that the rehabilitation doctrine did not apply. The Court ruled the doctrine was applicable in cases where there were substantial capital improvements and repairs to the same specific asset, usually involving a structure in a state of disrepair.

3. Prolong Useful Life of Property

We believe environmental remediation costs are properly deductible because they in general do not substantially prolong the useful life of the property, materially add to its value or adapt the property to a new or different use. Most cleanup costs also fail to rise to the level of a "general plan of improvement or rehabilitation."

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[4] Rev. Rul. 76-395, 1976-2 C.B. 16.

Environmental remediation costs are similar to repair costs in that they do not generally prolong the useful life of an asset. In Illinois Merchants Trust Co. v. Commissioner, 4 B.T.A. 103 (1926), the Court allowed the taxpayer to deduct as repair expenditures the costs for replacing rotting wood pilings which supported its building with concrete pilings. The Court said:

> A repair is an expenditure for the purpose of keeping the property in an ordinarily efficient operating condition. It does not add to the value of the property, nor does it appreciably prolong its life. It merely keeps the property in an operating condition over its probable useful life for the uses for which it was acquired. Expenditures for that purpose are distinguishable from those for replacements, alterations, improvements or additions which prolong the life of the property, increase its value or make it adaptable to a different use.. The one is a maintenance charge, while the other are additions to capital investment which should not be applied against current earnings.

Id. at 106.

Virtually all repairs prolong the life of property in some sense. In Illinois Merchants Trust, the Court also said "any repair increases the useful life of property over what it would have had without the repair." Id. at 107. It is clear that the comparative test under Treasury Regulation §1.162-4 must be one between the useful life of the asset prior to the condition necessitating the taxpayer's expenditure and its useful life after the expenditure is made.

In Midland Empire Packing Co. v. Commissioner, 14 T.C. 635 (1950), acq., 1950-2 C.B.3, the Court found that sealing the basement of a meat packing plant with a concrete liner to keep out oil seepage from an adjacent refinery did not increase the life of the building, make the building more valuable or alter its purpose and use from that which existed prior to the time the oil seepage began. In other words, the Court said the "expenditure did not add to the value...of the property over what [it was] before the event occurred. Id. at 641.

In Niagara Mohawk Power Corporation v. United States, 558 F.2d 1379 (1977), the Court held that the natural gas utility could deduct as a business expense the cost of installing clamps in pipelines in response to reports of leaks as well as the costs of installing clamps on joints that were investigated in advance of paving and repaving and found to be leaking. The Court stated the "clamping of joints to remedy leaks did not adapt the cast iron pipelines to a new or different use. It merely permitted them to perform the same function as before, namely, transporting gas to the plaintiff's customers.' Id. at 7494. That Court also said "a replaced joint obviously represents an "improvement" over a leaking joint, but that is not the test of a non-deductible capital "improvement" within the contemplation of the Code." Id.

We believe the removal of asbestos in a building does not increase its useful life since removal does not change the overall structure of the building. Asbestos removal is similar to the sealing of factory walls in Midland Empire Packing Co. Nor do we believe land remediation substantially prolongs the life of the land or creates a new property. Rather, such expenditures are used to return the land to its pre-contamination state.

4. Add Substantial Value

For similar reasons discussed above, A.G.A. does not believe environmental remediation costs materially add value to a property repaired. The proper test for environmental cleanup costs should be whether the expenditure materially increases the value of the property as compared with the value of the property prior to the time that the condition necessitating the expenditure became known to be hazardous. In Plainfield-Union Water Co. v. Commissioner, 39 T.C. 333 (1962), nonacq., 1964-2 C.B.8, the Court said the appropriate test is one "whether the expenditure materially enhances the value, use, life, expectancy, strength, or capacity as compared with the status of the asset prior to the condition necessitating the expenditure." In that case, the taxpayer cleaned and cement-lined cast iron water pipes used to supply acidic river water that subsequently caused tuberculation. The Court held that the cost of cleaning and cement-lining the pipes was a deductible repair since their useful lives, value and capacity were not increased or made suitable for a new or additional use.

Environmental cleanup costs oftentimes exceed any value produced for the taxpayer's business as a result of the cleanup. These costs are similar to medical expenses in that their primary benefit is a societal one to promote health and prevent disease. Many of these expenditures made for health purposes are deductible. A deduction was allowed under Code §213 for the costs of scraping lead paint from the surface of the taxpayer's personal residence.[5]

There are cases where it is recognized that if a taxpayer makes an expenditure in excess of the value produced thereby it is allowed to deduct the excess amount. In Cleveland Allerton Hotel, Inc. v. Commissioner, 166 F.2d 805 (6th Cir. 1948), the Court allowed the taxpayer who owned a hotel situated on land with an 80 year lease to deduct the excess costs involved in breaking the lease. In order to escape the lease the taxpayer paid a $441,250 fee whose value was worth no more than $200,000, and the Court allowed the taxpayer to deduct the payment in excess of $200,000. To the extent a taxpayer makes an expenditure that clearly will exceed any reasonable amount of income or value that can be expected to result from the expenditure (i.e., if the expenditure is required by environmental laws), the expenditure should be deductible, at least to the extent of the excess.

5. Different Use of Property

We do not believe environmental remediation costs create a new or different use of property. In Plainfield-Union, the Service had argued that cleaning and cementing the water lines permitted the pipes to shift from transporting river water, which comprised a different purpose and use. The Court disagreed, holding that the substantive use of the pipes was the same (delivering water).

D. Congress Should Provide Guidance in Light of Recent IRS TAMs

Congress should provide guidance that asbestos removal and replacement costs and environmental cleanup expenses are currently deductible under Code §162. The IRS has added much confusion in this area by abandoning longstanding tax principles to hold in recent TAMs that certain environmental remediation costs should be capitalized. In the asbestos TAM, the IRS National Office concluded that the costs related to the removal and replacement of asbestos were capital expenditures because they increased the value of the taxpayer's equipment by diminishing the asbestos health risk. In the PCB TAM, the Service found remediation expenditures, primarily those associated with soil recovery, such as excavation, transportation disposal of contaminated soil and backfilling, were to be capitalized to depreciable facilities, and not to the land. Only the legal fees with respect to claims against state and federal agencies and third parties were deductible to the extent they were incurred to defend the taxpayer's business or secure contractual rights in the PCB TAM.

In both TAMs, the IRS concluded that environmental cleanup costs produced future value because they helped the taxpayer avoid potential liability to governmental and third-party claims and made the facilities more attractive to potential buyers, investors and lenders. This position effectively would require that virtually all environmental cleanup costs should be capitalized, without regard to any other determining factors. The

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[5] Rev. Rul. 79-66, 1979-1 C.B. 114.

Service's position is inconsistent with the overwhelming weight of authority as discussed above, including its own pronouncements. Moreover, there would be no need for the Service to consider a bright-line test[6] in this area if the "avoidance of claims" theory advocated in the two TAMs are governing.

The conclusions reached in the TAMs are misleading. Payments made to avoid legal liability claims are not required to be capitalized simply because they allow the liability to be avoided. These payments do not produce future income or value.

It is well established that amounts expended to avoid liability claims do not produce future value solely because they allow claims to be avoided.[7] In Welch v. Helvering, 290 U.S. 111 (1933), the U.S. Supreme Court allowed the deductibility of legal fees incurred to defend the taxpayer against a lawsuit that threatened the viability of its business. The Court said that "the expense is an ordinary one [under Code §162] because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack." Id. at 114. Similarly, the Supreme Court has approved the deductibility of legal fees incurred by a doctor to defend a malpractice suit and expenses incurred by a landlord to defend a suit for injury suffered on the taxpayer's property. See Kornhauser v. United States, 276 U.S. 145, 153 (1928).

When formulating tax policy in this area, Congress should follow the clear "reflection of income" principle. A current expense should be capitalized where capitalization will better match the expenditure with the income that it is expected to produce. The taxpayer's method of accounting for capital items must clearly reflect income.[8] The U.S. Supreme Court has stated that the Code's capitalization and depreciation rules should attempt "to match expenses with the revenues...to which they are properly attributable, thereby resulting in a more accurate calculation of net income. Indopco, Inc. v. Commissioner, 112 S.Ct. 1039, 1043 (1992).

The Service did not follow the reflection of income principle in the TAMs. The Service violated the matching concept when it held that costs incurred to remove and replace asbestos installation from manufacturing equipment or PCB were to be capitalized. In those TAMs, the income that related to the capitalized expenses was from prior periods.

The Service also declined to follow legal precedent established in Plainfield-Union in rendering its decision in the TAMs. We believe the test established in that case should be applied to the tax treatment of environmental remediation costs. The Service concluded that Plainfield-Union was either not determinative as to whether the asbestos cleanup costs were deductible or was one of several factors in determining if P(cleanup costs were deductible. In the asbestos TAM, the Service concluded that becau asbestos was an integral part of the equipment when manufactured, the equipment cou not be valued prior to existence of the asbestos -- the condition necessitating t expenditure. However, the Service failed to recognize that the condition necessitating t expenditure was the scientific discovery of the harm caused by asbestos, and not t physical condition of the asbestos. The pre-condition value should be based on t equipment's value before the health hazards associated with asbestos became know

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[6] In March, 1993, the Internal Revenue Service (Service) announced that it was soliciting comments on the deductibility of environmental cleanup costs. See "Brown Lists Factors That Could Be Used To See If Cleanup Costs Must Be Capitalized," BNA Daily Tax Report (March 10, 1993), p.G-11; "IRS Struggles for Bright-Line Rules on Cleanup Costs," 58 Tax Notes 1408 (March 15, 1993). The Service identified five factors it considered relevant to the deductibility analysis. These factors included: 1) whether the cleanup costs relate to the creation of a new piece of property or to the cleanup of existing property; 2) whether the property to which the costs relate is owned by the taxpayer; 3) whether the property to which the costs relate will generate future income; 4) whether the remediation problem arose during the taxpayer's normal operations or whether the property was acquired with the problem in place; and, 5) whether the taxpayer's expenditure is voluntary or imposed by a judicial or governmental decision.

[7] In Rev. Rul. 9240005 (June 12, 1992), the Service said "[h]istorically, courts have ruled while amounts paid to produce future income must be capitalized, amounts paid to reduce or eliminate expenses are deductible."

[8] Treas. Reg. § 1.446-1(a)(4)(ii).

The Service further concluded that costs incurred in the TAMs to bring proper into compliance with regulatory requirements increased the value of the property ar should be capitalized. However, there are numerous cases reaching an opposi conclusion. Among those cases are: Midland Empire Packing (concrete liner added a basement meat storage facility at request of federal meat inspector); Regenstein Edwards, 121 F. Supp. 952, 953 (D. Ga. 1954) (steel columns required to brace saggin floor by city building inspector). It is apparent to us that whether an expenditure is mad in order to comply with a law or regulation should have no bearing, as in the TAMs, o the deductibility of the expense.

III. Compensatory Damages Under Environmental Statutes

A.G.A. opposes provisions of H.R. 2441, a bill introduced by Rep. Gerry Studds D-MA, on June 16, 1993, to disallow deductions for amounts paid pursuant to settlements and for compensatory damages under various environmental laws. This bill could stifle the ability of companies to conduct business and defend themselves in lawsuits. By requiring companies to capitalize such expenses, many companies would be financially unable to provide funds for cleanups.

The various business enterprises and activities of natural gas companies may expose them to a number of environmental statutes. Among these are CERCLA or the "Superfund." CERCLA supplements the Resource Conservation and Recovery Act[9] by giving the government a means to take action against current problems created by past improper disposal practices. CERCLA's legal mechanisms are activated when there is a release or threatened release of a hazardous substance from a facility. Under the statute, the government has authority to require a cleanup of inactive hazardous waste sites.

CERCLA enables the U.S. Environmental Protection Agency to seek reimbursement from responsible parties for its actions in abating pollution from a hazardous substance release or require such parties to undertake remediation. A current owner could be liable under the statute even if such owner did not operate a facility at the site at the time of disposal. CERCLA covers four types of parties: current owners or operators of facilities; owners or operators at the time of hazardous substance disposal; those arranging for the disposal, treatment or transportation of hazardous substances; and those transporting the substances.

As described above, the costs incurred in defending a business and amounts paid in settlements should be a part of the costs of operating a business. In Ditmars v. Commissioner, 302 F.2d 481 92d Cir. 1962), the Court stated:

> What is ordinary is that the conduct of almost any trade or business will give rise to claims, many invalid but some valid, resisting such claims, paying judgements rendered on some, and settling others, is thus an "ordinary and necessary" expense of "carrying on any trade or business" within section 162.

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[9] 42 U.S.C. §6901 et seq. The Resource Conservation and Recovery Act is a complex statute enacted in 1976 to protect public health and to encourage the recycling, reuse and treatment of hazardous wastes.

Id. at 485. A.G.A. supports the applicability of this case to the deductibility of compensatory damages paid in compliance with certain environmental laws.

IV. Excise Tax on Lobbying of Tax-Exempt Entities

A.G.A. adamantly opposes proposals that would impose a 30 percent excise tax on the lobbying activities of tax-exempt organizations. This proposed change would hamper the ability of tax-exempt organizations to exercise free speech in contacting their elected officials and governments.

"The Omnibus Budget Reconciliation Act of 1993" (Budget Act), Public Law 103-66, already unduly burdens tax-exempt organizations, such as trade associations, by giving them the option of maintaining detailed records and disclosing annual reports to members regarding lobbying activities, paying a proxy tax of 35 percent on lobbying expenses or seeking a waiver from the Act's requirements. That Act impedes trade associations in their lobbying efforts.

Under the Budget Act, for each taxable year, trade associations must report to the Service on their total lobbying expenses and the total amount of dues to which such expenses are allocable. In addition, as part of their annual dues assessment, associations must provide members with a reasonable estimate of the portion of their dues that will be non-deductible for the coming year. This notification requirement extends to all voluntary payments to trade associations and special assessments by associations. Notification must be made at the time of payment or assessment.

Trade association's may, in lieu of the disclosure and reporting requirements, pay taxes on their lobbying expenses directly -- at the highest corporate tax rate. The tax would be levied on lobbying expenses up to the total dues for income for that year.

A.G.A. is not an association that can avail itself of the general waiver provisions in the Budget Act. Some trade associations that receive 90 percent or more of their dues from individuals may apply to the Secretary of the Treasury for a waiver from the non-deductibility requirements of the Budget Act.

If an association's actual lobbying expenses for a given year exceed the estimate provided to members at the beginning of the year, then the association is required under the Budget Act to pay a proxy tax on the excess amount or seek permission from the IRS to roll over the expenses to the following year.

These burdensome requirements contained in the Budget Act will only be enhanced by the proposed excise tax. Moreover, many trade associations would be forced to alleviate or substantially limit their lobbying if Congress adopts an excise tax in addition to the current proxy tax provisions.

V. Business Meals and Entertainment Expenses

A.G.A. urges Congress not to adopt a proposal to either require taxpayers to provide written substantiation of any meal or entertainment expense claimed as a business deduction, or alternatively, require written substantiation of any meal or entertainment expense in excess of $10. Businesses would face an undue burden in providing written verification of deductible items, regardless of the amount. We believe a threshold of $10 is too small.

The House-Senate conferees for the Budget Act determined that a threshold from $25 to $20 was unwarranted.[10] Likewise, it is equally unwarranted for Congress to consider adopting a threshold below that rejected by the conferees. In light of the limitations imposed on the deductibility of business meals and entertainment expenses in the Budget Act, it is our belief that most taxpayers will make these expenses with prudence.

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[10] "Omnibus Budget Reconciliation Act of 1993," Conference Report Of The Committee On The Budget, Report No. 103-213 (p. 582).

VI. Bonus Withholdings

A.G.A. opposes a proposal to increase the rate of withholding on bonuses from 28 percent to 36 percent. Some of our member companies make supplemental wage payments to rank and file employees. An increase in the withholding rate to 36 percent would make this rate greater than the 28 percent (or less) income tax rate applicable to their rank and file employees. We urge Congress not to adopt this proposal.

VII. Conclusion

A.G.A. supports clarification by Congress that expenses incurred for environmental remediation costs are currently deductible under Code §162. Congress should not require that these expenses be capitalized. A.G.A. opposes a proposal that would disallow deductions for compensatory damages paid under certain environmental laws.

A.G.A. also urges Congress not to adopt proposals that would curb the ability of tax-exempt organizations to engage in free speech and lobbying activities before federal and state governments. A proposal to require written verification of all or a de minimis amount of business meals and entertainment expenses should not be enacted. Finally, A.G.A. opposes a proposal to increase the withholding rate on employee bonuses.

This statement is submitted by Henry C. Cashen and John C. Dill, representing the law firm of Dickstein, Shapiro and Morin. We serve as Washington Counsel for the American Greyhound Track Operators Association (AGTOA). AGTOA is strongly opposed to two proposals involving the further taxation of wagering activities which are pending before the Subcommittee.

AGTOA is a non-profit corporation founded in 1946. It's membership consists of the owners and operators of greyhound racing tracks located throughout the United States. Greyhound racing is currently legal in 17 States. Membership is open to all lawfully licensed greyhound tracks whether they be owned by individuals, partnerships or corporations.

Greyhound racing is the sixth largest spectator sport in America. In 1992, the attendance at AGTOA's member tracks exceeded 28 million fans. Approximately $3.2 billion was wagered at these tracks, and out of that pari-mutuel handle, State and local governments received over $207 million in revenues.

Increase Withholding Rate on Gambling Winnings

The Subcommittee has a proposal pending before it that would increase the withholding rate on gambling winnings from the present rate of 28% to 36%. Under current law, individuals are subject to withholding on gambling winnings if the amount of such winnings exceeds $5,000 and is at least 300 times as large as the amount wagered.

This proposal, which would increase the withholding rate on gambling winnings to equal the highest tax rate, is based on little or no tax policy justification. Tax compliance is not a problem -- tracks currently must identify and report to the IRS any customer whose winnings are in excess of $600.

Increasing the withholding rate to 36% will only compound the existing problems with withholding. Unlike State lotteries, the pari-mutuel industry relies heavily on multiple bets over the course of a race card to generate income. A winning customer hopefully will re-wager his funds on subsequent races during the day. This re-wagering, or "churning" of dollars in the terminology of the racing industry, is crucial to the health of AGTOA tracks. If a customer is subjected to withholding after a successful wager, then his or her subsequent bets will be reduced by this amount of withholding, thus depriving the tracks, the animal owners and other customers of the benefits of a larger betting pool.

Any withholding is damaging to the health of industries such as greyhound racing which rely on the churning or velocity of money. This proposal is particularly damaging for two additional reasons. First, it comes hard on the heels of an increase in wagering withholding that occurred last year. A provision in the 1992 omnibus energy bill raised the withholding rate from 20% to 28% beginning January 1993. Obviously, each increase in withholding removes more money from circulation at the tracks. In increasing the top tax rate to 36% just this year, the Administration and the Congress recognized that only a very small percentage of taxpayers (about 1.2%) have taxable incomes high enough to put them in that tax bracket ($140,000 for married couples, $115,000 for singles). Certainly, very few greyhound track patrons have incomes high enough to put them in that 36% bracket. Nevertheless, under this proposal, any bettor who happens to win in excess of $5,000 would see his or her winnings withheld at the 36% rate even though the bettor's actual effective tax rate most likely is much lower. This will certainly result in the government receiving a short-term windfall in excess withholding. Further, the proposed 36% withholding rate for gambling winnings is far in excess of the withholding rates applicable in other cases, such as backup withholding on interest and dividends and withholding on pension distributions, suggesting that the gaming industry is being singled out for punitive treatment.

As noted above, this is not a compliance issue -- the IRS still will be informed of winnings and, in many cases, will receive 28% of the winnings at issue as advance payment of taxes due on them. There is no logical policy reason for increasing the withholding rate to 36%. The only result will be to hurt the gaming industry, and the thousands of persons it employs. Even more troublesome, by pegging the withholding rate at the highest tax rate rather than the lowest tax rate, the government is receiving an interest free loan from taxpayers who ultimately may be paying taxes in a lower bracket.

Limitation on Deductions for Wagering Losses to 80% of the Amount Otherwise Deductible

The Subcommittee has a proposal pending before it that would limit to 80% the deduction of wagering losses against wagering gains. Under current law, individuals may deduct 100% of wagering losses from gains, provided such losses and gains occur in the same taxable year. Gambling losses cannot be used to offset non-gambling income.

The proposal pending before the Subcommittee to limit such deductions to 80% of the amount of the loss would result in a severe tax penalty being paid in some cases. If, for example, an individual had total wagering losses of $10,000 during a year against total wagering gains of $10,000, the loss would equal the gain and he or she would owe no taxes since no net income had been received. Under the proposal, a similarly situated taxpayer would have to pay taxes on $2,000 of "phantom" income he or she never received, thus converting a net income "wash" into a tax penalty based on the nature of activity. In effect, this proposal would act as a tax increase on wagering.

This proposal is directly contrary to the long-recognized tax policy principle that a taxpayer should be taxed only on his net income from an activity, with allowances for expenses and losses. If, however, the amount of wagering losses that may be deducted is reduced by 20%, persons who indulge in perfectly legal pari-mutuel gambling will be hit with tax even when they had no net income. Most track patrons come to the track for entertainment. Their winnings and losses usually even out, and they have a good time. This proposal would lead to the incongruous result that a patron who "breaks even" at the track would be treated as though he "won" for tax purposes and would face a tax penalty for his outing at the track. Again, this appears to be a purely punitive measure aimed at the pari-mutuel industry that has no justifiable tax policy basis.

It may be logical to limit the deductions for business meals and entertainment to 50% on the theory that such activity is not necessary to conduct business. Limiting the deduction for wagering losses does not fit into the same category -- the act of winning or losing wagers is not antecedent to some other activity that can take place without wagering -- wagering is the activity. It makes no logical sense to place a limit on the deductibility of losses from such legal activities.

This proposal will have a substantial negative impact on pari-mutuel racing facilities across the country, and will particularly impact on regular fans and bettors who provide the industry with a large portion of its cash flow. Driving bettors away from race tracks will, in turn, adversely effect the revenue flow to States which depend on legalized gaming for funds.

We urge the Subcommittee to reject both of these measures on the basis of fairness and on the basis of the negative impact on both the pari-mutuel industry and the taxes which flow from our industry to the States.

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Testimony of
American Horse Council
to the
Subcommittee on Select Revenue Measures
Committee on Ways and Means
September 22, 1993

The American Horse Council (AHC) appreciates the opportunity to present this statement to the Subcommittee on Select Revenue Measures in opposition to those proposed revenue raising measures which would increase withholding on gambling winnings from 28% to 36%, limit the deduction from wagering losses to 80% of the amount otherwise deductible and increase the wagering tax on state authorized wagers from 0.25% to one percent.

The American Horse Council is the national trade association for the horse industry. It includes 191 equine organizations representing over 1 million horse owners and breeders who are involved in every facet of the horse business as well as the major racing organizations in the United States.

The U.S. horse industry is a very diverse $15.2 billion industry that employs hundreds of thousands. Horse owners and breeders spend about $13 billion in annual investment and maintenance costs for their horses. $200 million worth of horses are exported each year. Horse farms and training facilities provide green space, often in areas that are being threatened by encroaching urban areas.

Included among the organizations represented by the AHC are the major associations of race tracks, breeders groups and horsemen's organizations which collectively comprise the pari-mutuel horse racing industry. Our individual members include owners, breeders, riders, drivers, trainers, veterinarians, farriers and other professionals whose livelihood depends on racing and the horse.

It is on behalf of this pari-mutuel sport and business, a major segment of the American horse community, that we present our views on the proposed revenue raisers which will adversely affect our industry.

THE PARI-MUTUEL RACING INDUSTRY

Pari-mutuel horse racing is legal in 43 states and involves the racing of Thoroughbreds, Standardbreds, Quarter horses, Arabians, Appaloosas and Paints. Off-track and inter-track wagering is legal in 41 states. There are over 192 racetracks in the U.S. In 1992, 72 million people attended the races, wagering $14.1 billion and generating over $600 million in direct state and local revenue from pari-mutuel taxes, track licenses, occupational licenses, admission taxes and miscellaneous fees.

Although wagering on horse races is permitted in 43 states, there is an active horse business in all 50 states. In many, the cash contribution of the racing and breeding industry to local economies is dramatically large and the industry ranks among the state's most significant economic entities.

In California and New York, for example, horse and horse related businesses account for cash contributions to each state's economies which exceed $2 billion annually. In Florida, Illinois, New Jersey, Ohio, Pennsylvania, Kentucky, Maryland and Michigan, the economic impact has been estimated at or around $1 billion annually. The employment accounted for by horse racing businesses and farms in each of these states ranges from 10,000 to 80,000 jobs. Many other states, including Arizona, Oklahoma and Texas, have extremely large and active horse industries.

The horse racing industry has suffered in the last several years as have a number of other industries. We have seen tracks close, such as Roosevelt Raceway in New York, Longacres Park in the State of Washington, Liberty Bell in Philadelphia, Brandywine Raceway in Delaware and in 1993 there was no live racing at Canterbury Downs in Minnesota and Quad City Downs in Illinois and Garden State Park in New Jersey have not sought racing dates for 1994.

Prices for yearlings and horses in training have fallen dramatically from their highs in the mid-80's.

The total betting handle (gross amount bet) over the last ten years has not kept pace with inflation growing at the meager average annual rate of 1.89% and due to the expanded gambling market, particularly lotteries, the industry is receiving a smaller percentage of the gambling dollar.

When racetracks close and costs increase but handle decreases in real dollars you inevitably have a loss of jobs and the tax revenues that flow from that income.

Any tax measure which will reduce the total betting volume will only lead to a further reduction of jobs and eventually more track closings and bankruptcies of breeding farms and training centers.

PROPOSED INCREASE IN WITHHOLDING TAX FROM 28% TO 36%

Wagering on the horses is the engine that drives this industry. It determines the size of purses (the return to the horsemen), the profits or lack thereof for track operators and the money for breeding funds, and state and local governments. Any tax measure that will adversely affect wagering will reduce the amounts available to horsemen, track operators, and state and local government.

In pari-mutuel wagering the fan is not betting against the track operator or "house" but is betting against his peers, his fellow bettors. Their collective bets form the wagering pools from which the track, on average, takes out 20.6% so that for each betting dollar the return to the winning fan is 79.4 cents. The 20.6 cents represents gross revenue to the industry which is split among the track operators, horsemen and state and local government. The industry relies on winning bettors to reinvest their winnings on subsequent races so that the money is churned several times during the course of that day at the races.

If you withhold more than 20.6 cents per betting dollar you are returning less money the winning fan and there will obviously be less money to churn which in turn means less money bet during that day which means less money retained by the industry.

In 1992 the total pari-mutuel betting volume on horses, grehounds and jai alai (handle) was $17.8 billion.

The amount returned to the bettors was $14.1 billion (79.4%).

The amount retained by the industry and government (takeout) was $3.6 billion (20.6%).

The amount retained was split as follows:

Tracks	$1.4 billion	(8%)
Purses	$1.4 billion	(8%)
States	$712 million	(4%)
Federal withholding	$106.8 million	(0.6%)

If you increase the federal withholding from 28% to 36% you will increase federal withholding by 28.6%. Assuming the 1992 base numbers, federal withholding would go from $106.8 million to $137.3 million, an increase of $30.5 million. This, of course, would reduce by like amount the money returned to the bettors and available to be rebet or churned.

Economic studies have been done on the impact of increasing what is taken out of each betting dollar and it is estimated that for each 1% in the money taken out of play (20.6% to 20.8%) the overall amount bet will decrease from 1.5% to 2.1% or a loss in total betting volume of between $267 million and $373 million. The extra $30.5 million taken out of play amounts to an increase in takeout of 8/10ths of one percent and will result in a loss of gross revenues to the industry of between $45 million and $64 million which includes a loss in state revenues of between $9 and $13 million.

A loss of this magnitude at a time when the entire industry is struggling is bound to lead to a further loss of jobs and bankruptcies by trainers, breeding farms and the small businessmen like the feed suppliers and other vendors that make up our industry.

Increasing the withholding is not only bad for our overall business but is also unfair to the racing fan, and serves as a disincentive for a fan to come to the races.

It is not uncommon for a fan to bet all day and lose and yet hit a winner in the last race. If our hypothetical fan invested $8,000 on the previous eight races before his winner and his winning ticket pays $5,000, he is a net loser for the day and yet under Federal withholding he still must give up 28% of his $5,000 prize. The current porposal is making an unfair and unjust practice more unfair by increasing the amount withheld.

It is also unfair to the racing fan who by and large is in the middle income tax bracket or lower to be taxed at the 36% rate. The 36% tax rate is reserved for the wealthiest of Americans who have incomes over $115,000 for single filers and $140,000 for joint filers. Why is it necessary to single out gambling winnings for a special high tax rate?

A number of racing fans do not itemize their deductions and therefore cannot claim any offsets due to withholding during the year. He or she is being penalized for enjoying a day at the races and having the good fortune of an occasional winner but not enough deductions to claim an offset for withholding. This unjust result is not in keeping with a tax system based on fairness and the ability to pay.

If the fan does have sufficient deductions to file a long form the amounts withheld will generally be reclaimed by way of offsetting any taxes owed so that the Treasury is no further ahead by use of this discriminatory withholding method.

Just last year Congress raised the withholding rate from 20% to 28% and in our view to raise the rate again so soon will only turn off our fans and discourage their attendance at the races.

GAMBLING LOSSES

The second revenue raiser limiting deductions to 80% of what is "otherwise allowable" is guaranteed to drive bettors from the track. This proposal converts 20% of a bettors losses into income on which he or she must pay taxes. Are we going to apply the same rule to securities traders or commodities brokers so that only 80% of their losses can be used as deductions? This very proposal is punitive to racing fans who either are professional gamblers or regular and casual players who watch and handicap races, bet for entertainment and pursue the sport as a leisure time activity. If the federal government wants to hurt a substantial industry that provides thousands of jobs to many unskilled workers we can think of no better policy change.

For example, let's describe a horse player who has a bankroll starting the year of $100,000 and manages during the course of the year to collect $400,000 in payoffs but by year end has lost it all. Under existing rules the fan would have winnings of $400,000 which would be offset by losses of $400,000. Under the proposed change he could deduct only $320,000 and would owe taxes on $80,000 which is non-existent "income". Both this proposal and the withholding increase fail to take into account the dynamics of betting within the pari-mutuel industry. The bettors for the most part are regular customers of racing who bet and rebet several times a day. They arrive with betting budgets and when it is used up they leave. Their betting budgets represent the cost of entertainment to them.

The types of proposals being considered will not only drive fans away from tracks and betting outlets but will also increase the business of the illegal local book. They do not bother with withholding rules, will give track odds and even credit to their favorite customers.

INCREASING THE EXCISE TAX

While the pari-mutuel horse industry is not directly affected by this proposal we oppose this change. The gambling industry including the pari-mutuel horse racing industry will in 1993 be impacted by the taxes imposed by the Omnibus Budget Reconciliation Act of 1993. Turf clubs and restaurants at racetracks will be impacted by the reduction in expenses for meals, entertainment and club dues. The increase in fuel taxes will also impact many racing fans who regularly drive to the track. This industry will already be doing its share to shoulder the burden of deficit reduction. The excise tax increase, the 80% deduction proposal and the increase in withholding are designed to hurt the wagering industry and to benefit other interests. Horse racing and wagering are legitimate activities within our society responsible for hundreds of thousands of jobs and fairness demands that they not be singled out and harmed by unjust tax policy.

Thank you for your attention to our testimony.

AMERICAN PETROLEUM INSTITUTE
STATEMENT REGARDING
MISCELLANEOUS REVENUE RAISING PROPOSALS

The following comments, regarding certain revenue raising proposals which are the subject of a hearing before the Subcommittee on September 21, 1993, are submitted on behalf of the American Petroleum Institute (API). API represents approximately 300 companies involved in all aspects of the oil and gas industry, including exploration, production, transportation, refining and marketing.

DOMESTIC INCOME PROPOSALS

A proposal to amend the like-kind exchange rules to require that the Code section 1031 property received must be "similar or related in service or use" to the property exchanged, except in the case of condemnations.

This proposal must be approached cautiously. It is difficult to understand the rationale for changing a well settled area of the tax code which serves to facilitate the conduct of business. The provisions of section 1031 were designed to allow businesses to defer tax on transactions which did not generate cash until the property received in the transaction was disposed of because the taxpayer's investment continues unliquidated. In these transactions, the taxpayer is not allowed a stepped up tax basis in the property received. Rather, the taxpayer must take a carryover basis in the property received.

The provisions of section 1033 of the Code relate to involuntary conversions, such as theft, seizure, condemnation, etc. The provisions of section 1033 are more liberal with respect to the timing of the acquisition of the replacement property than those of section 1031, and section 1033 contains the "similar or related in service or use" language. While this language may be appropriate for use in section 1033, it would not be appropriate for the widely applicable but less generous provisions of section 1031.

A change in the like-kind exchange rules will mean that taxpayers who receive no cash in a trade will incur a tax liability, which will have several unfortunate consequences. For example, the taxpayer may decide the transaction is not economic if it is forced to borrow funds to pay the tax liability or if it is forced to use working capital to pay the tax liability. If the transaction is not consummated, the highest and best use of the properties may never be realized. This may have the effect of reducing employment or otherwise reducing economic growth.

Further, the uncertainty generated by such a change will retard business activity. For example, it must be clear that the exchange of an operating mineral interest for a nonoperating mineral interest is similar or related in service or use. It must also be clear that unimproved realty to be used for a service station exchanged for an existing service station site is also similar or related in service or use. Similarly, a gas plant should be eligible for section 1031 treatment when exchanged for a refinery. Under current law, there is no doubt as to the consequences of these transactions. Under the proposal, the ability of businesses to compete will be harmed by both the resources expended in resolving issues of interpretation as well as the net negative economic effect of any amendment.

A proposal to disallow deductions for compensatory damages under certain environmental laws.

This proposal is similar to H.R. 1973 and H.R. 2441 which would deny deductibility of environmental settlement costs and compensatory damage payments under certain environmental laws. API opposes any legislation that would disallow deductions for settlement costs or compensatory damages under environmental laws.

The U.S. income tax system is designed to levy a tax on the net profits of a taxpayer -- not on gross revenue. The Tax Code, as a matter of sound tax policy, has long recognized that business expenses, even those arising from unusual or unexpected events, reduce profits and taxable income. Legislation that would deny a legitimate business deduction for cleanup costs and related expenses, such as environmental settlement costs, creates the possibility that phantom taxable income arises where a taxpayer has out-of-pocket expenditures. No taxpayer intends to cause environmental damage, for example from a hazardous substance discharge, but if it does occur, the cleanup and other costs are actual expenses that reduce profits and taxable income.

A fundamental problem with proposals such as H.R. 1973/2441 is that they send exactly the wrong message: it would discourage cleanup expenditures and related environmental settlement costs that in the public interest should clearly be encouraged. Because the level of cleanup is usually directly related to cost, this proposal would encourage behavior that will lessen cleanup. The cleanup of oil and hazardous substances unquestionably serves the public interest by restoring the environment, and Congress should encourage rather than frustrate these expenditures.

Numerous specific penalties exist under federal and state civil and criminal laws which are designed to ensure compliance with environmental standards. For example, under the Clean Water Act, in the event of an oil spill, the operator may be subject to administrative fines ($5,000 for each offense), and civil penalties (up to $25,000 per day). Failure to comply with orders under CERCLA may result in treble damages to the United States and civil penalties of up to $25,000 per day of noncompliance. Failure to comply with orders under RCRA may result in a termination of the facility's authority to operate and a civil penalty of up to $25,000 per day of noncompliance.

Proper enforcement of these laws provides adequate penalties for noncompliance and adequate incentives to ensure responsible behavior. Moreover, from time to time, Congress has in the tax code disallowed certain deductions whose allowance would frustrate public policy. For example, IRC section 162(f) provides disallowance of deductions for any fine or similar penalties paid to a government for the violation of any law. Proper enforcement of this section provides further incentives to ensure responsible behavior.

Finally, the proposal penalizes only U.S. taxpayers, not foreign companies which may not be subject to the U.S. tax code, thereby giving foreign companies a competitive advantage over U.S. business because of the additional after-tax cost associated with U.S. business activities.

A proposal to clarify the treatment of environmental remediation costs by (1) specifying the types of such costs that must be capitalized, or, alternatively, (2) requiring that all such costs be amortized over a uniform period of years.

Environmental remediation expenditures relate to cleaning up problems resulting from past practices or reducing contamination from present operations. Two recent technical advice memoranda by the Internal Revenue Service (TAM 9240004, June 29, 1992, and TAM 9315004, December 17, 1992) have raised fears of taxpayers that the IRS is trying to reinterpret well-established law in the capital v. expense area, and have led to calls on the part of some for a legislative solution.

API believes that analysis of current law relating to the deductibility of repairs under IRC section 162 supports the position that most environmental remediation expenditures are currently deductible because they do not create a separate asset, do not materially increase the useful life or value of an existing asset, or do not adapt an asset to a new or different use. Therefore, at this time we do not see the need for additional clarifying legislation.

Moreover, API's members are very concerned about the implications of proposals to amortize all such costs over a uniform period of years. Such proposals would overturn well established law in this area, violate the fundamental tax principle of matching income and expenses, and contravene the important national social policy of environmental protection.

The primary justification for denying a current deduction for expenses which result in a future benefit extending substantially beyond the end of the taxable year is the principle of matching expenditures to the income or benefit they produce. In order to require capitalization, courts have held that the future benefit received from the expenditure must be direct. Typically, there is no such direct future benefit from environmental remediation expenditures; they are incurred because of governmental rules and regulations, often as a result of advancements in science which identify hitherto unknown hazards, and they are related to past practices which generated past income. It would be difficult to imagine a situation where such costs are incurred for the generation of incremental income from the property to which they relate; nor will they be incurred to avoid or reduce future expenses. In fact, environmental cleanup costs have to be incurred irrespective of their adverse impact on income and expense. Therefore, to amortize those costs over a number of years would violate the fundamental income/expense matching principle.

Equally important, legislation to require amortization of cleanup expenditures would frustrate the national policy of promoting cleanups by stretching out their recovery, thereby increasing their net cost to taxpayers. Cleanup of hazardous wastes clearly serves the public interest by restoring the environment, and Congress should encourage rather than penalize these expenditures.

A proposal to extend the private inurement rule to organizations exempt from tax under code Section 501(c)(4).

This provision is the same as Section 101 of H.R. 2735, the Miscellaneous Revenue Act of 1992. The committee report to that bill states that the prohibition on private inurement contained in the amendment is the same prohibition that now applies to all charitable organizations exempt from tax under Code section 501(c)(3).

A number of API's members participate in social welfare organizations formed for the purpose of protecting the environment by cleaning up oil spills. In Rev. Rul. 79-316, 1979-2 C.B. 228, the Internal Revenue Service determined that such organizations, properly organized and operated, qualified as tax-exempt from tax under IRC Section 501(c)(4). Subsequent rulings and determination letters have confirmed that entities meeting the standards of this revenue ruling qualify under Section 501(c)(4), and the oil spill response organizations have been established relying on these determinations and rulings.

It is our understanding that no question has been raised either with regard to the IRS's analysis of oil spill response organizations in Revenue Ruling 79-316 or with regard to its administration of the status of these organizations based on this ruling. Both the ruling and IRS's administrative decisions are based on the assumption that private inurement is prohibited under section 501(c)(4).

Because a change in the statutory language might otherwise create unintended and unnecessary uncertainty that could interfere with the functioning of response organizations, we request that report language be included clarifying that "This amendment is not intended to alter the holding and reasoning of Rev. Rul. 79-316, 1979-2 C.B. 228."

FOREIGN SOURCE PROPOSALS

A proposal to change the foreign tax credit to a deduction.

General Comments

U.S. corporations, citizens and resident aliens are subject to the U.S. income tax laws on their worldwide income. Therefore, since income derived from sources outside the United States is normally taxed by the country of origin, there exists a potential for double taxation. It has been the policy of the United States for seventy-five years to neutralize the effects of international double taxation by providing a credit for foreign taxes paid on foreign-source income earned by U.S. taxpayers. Other nations generally use this credit approach or some type of mechanism which exempts foreign-source from taxation.

The neutrality provided by the foreign tax credit during this 75-year period has enabled U.S. business to compete abroad with foreign-based companies. The vigor of foreign competition must not be underestimated. For example, according to a recent survey of 1992 worldwide sales, there was no U.S. company among the top five; and, the three U.S. companies among the top 10 accounted for only 28% of the sales of that group.[1]

Continued international involvement of U.S. companies is critical to the economic well-being of the United States. In 1992[2], $33.3 billion of earnings of foreign affiliates were repatriated, while only $19.5 billion of new funds were sent abroad--a net inflow of $13.8 billion. Another $14.3 billion of fees and royalties and $5.4 billion for services were received by U.S. parents from foreign affiliates. Hence, the total net capital inflow was $33.6 billion. According to Commerce Department data, U.S. multinational companies account for approximately 60% of U.S. exports.[3] Moreover, foreign affiliates of U.S. companies assure a substantial portion of U.S. exports; for 1991, the most recent available data, $115 billion of U.S. merchandise exports of $422 billion went to foreign affiliates.[4]

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[1] Business Week, July 12, 1993, "The Global 1000", at 53.

[2] See, U.S. Department of Commerce, Survey of Current Business, Vol. 73, July 1993, at 91 et seq.

[3] Id., at 45.

[4] Id., at 45.

The Petroleum Industry

The petroleum industry is the largest single source of net remitted earnings from U.S. foreign investments. In 1992 petroleum companies accounted for $8.9 billion of the total net remitted earnings (26.7%). Interest, fees and royalties from petroleum affiliates provided another $1.4 billion[5]. Thus, the total net petroleum foreign exchange inflow was $10.3 billion (31% of the net capital inflow of $33 billion).

It is vital to the national security that U.S. petroleum companies retain their ability to continue to participate in diversification and enhancement of international petroleum supplies. Even with a vigorous national effort to develop new domestic energy supplies and conserve domestic energy usage, most forecasts show the United States will continue to import large quantities of oil in the future. The inherent insecurity of a high level of petroleum import dependency would be increased by relying on foreign companies to provide those imports--as would inevitably follow if U.S. petroleum operations were double taxed through disallowance of the foreign tax credit.

Legislative History of the Foreign Tax Credit

Interpretation of any provision of the Internal Revenue Code requires thoughtful consideration of its legislative purpose and history.

Section 901

In 1918, the United States became the first country to permit taxpayers to credit foreign income taxes on a world-wide basis.[6] The rationale for the provision was explained in the House Committee Report as follows:

> Under existing law a citizen of the United States can only deduct income, war, or excess profits taxes paid to a foreign country from net income. With the corresponding high rates imposed by certain foreign countries the taxes levied in such countries in addition to the taxes levied in the United States upon citizens of the United States places a very severe burden upon such citizens.[7]

As is widely recognized, the principal burden which Congress wished to alleviate was the burden of double taxation. Simply stated, because the United States taxes its citizens and residents on a world-wide basis, a credit mechanism is needed to avoid a harsh and undue burden on taxpayers because of similar taxes imposed by different, but overlapping jurisdictions. By permitting foreign taxes on foreign income to be offset against the U.S. tax liability for such income, the Congress also recognized implicitly that primary tax jurisdiction resides in the country where the income is earned.[8] Likewise, foreign jurisdictions provide similar credits or exemptions to their taxpayers for income earned in the United States.

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[5] Id., at 94.

[6] Rev. Act of 1918, §§222, 238, 240(c).

[7] H.R. Rep. NO. 767, 65th Cong., 2d Sess. 9 (1918), 1939-1 C.B. 93.

[8] See, e.g., Hearings on "Windfall" or Excess Profits Tax Before House Comm. on Ways and Means, 93d Cong., 2d Sess. 145 (1974) [Hereinafter cited as "Windfall" or Excess Profits Tax Hearings].

Section 903

Section 903, in essentially its current form, was added by the Revenue Act of 1942.[9] The provision resulted from an amendment added by the Senate Finance Committee and the Committee's report indicates that the provision was intended to expand the scope of creditable taxes to include those which, although not related to net gain or income, were in lieu of an income tax generally imposed.[10]

Limitations on the Foreign Tax Credit

To further insure that the foreign tax credit mechanism carries out its congressional purpose, Congress has introduced limitations on the amount of the foreign tax credit and the types of income which may be offset by tax paid to foreign countries. These limitations, contained in Section 904, serve the policy of protection of the U.S. tax base in the context of inbound investment by foreign investors in the United States and outbound investment by U.S. investors abroad.

Foreign oil and gas extraction income (FOGEI) and foreign oil related income (FORI) are subject to less favorable foreign tax credit treatment than for other industries. In particular:

- excess foreign tax credits on FOGEI cannot be applied against non-FOGEI income (Code section 907(a));
- foreign taxes on FORI cannot be credited in situations where the foreign government poses higher taxes on FORI than on other income (Code section 907(b));
- the treasury regulations for determining the creditability of foreign taxes are far more restrictive in the case of foreign extraction taxes (Treas. Reg. §§1.901-2 and 1.903-1); and
- in the calculation of U.S. tax on foreign income, a significant portion of FORI is subject to loss of "deferral" under the subpart F provisions of Code (Code section 954(a)(5) and (g)).

All of the limitations and restrictions noted above apply for purposes of the regular tax as well as the alternative minimum tax. In addition, solely for purposes of the alternative minimum tax, the foreign tax credit is limited to 90% of the amount of a taxpayer's alternative minimum tax. Thus, a taxpayer with foreign income subject to foreign tax is nonetheless subject to U.S. tax on the same income in circumstances in which the limitation applies.

Hearing Proposal

A reversal of the seventy-five year old policy to permit taxpayers with income from sources outside of the United States to obtain a credit for income taxes paid to foreign jurisdictions with respect to such income would be an imprudent legislative action. Such a change would insure failure to achieve any of the policy objectives for taxation of international income. Earlier this year, the Treasury set forth four substantive policy objectives as well as a fifth objective of administrative simplicity. (International Tax Reform, An Interim Report, Dept. of Treasury, January 1993). These objectives were:

- preservation of the U.S. tax base;

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[9] Rev. Act of 1942, §158(f).

[10] S. Rep. NO. 1631, 77th Cong., 2d Sess. (1942), 1942-2 C.B. 543.

- consistency with accepted international norms;
- economic efficiency; and
- competitiveness.

The proposal would undermine the objective to preserve the U.S. tax base by overstepping the reach of U.S. tax jurisdiction to include in income amounts already subjected to tax by a foreign jurisdiction. Ultimately, because of the inability of U.S. taxpayers to compete in such an environment, the overall tax base of the U.S. would be depleted rather than enlarged.

The proposal would be inconsistent with accepted international norms. Virtually every nation with any substantial amount of international trade provides some mechanism for avoidance of double taxation of its citizens and residents. Since the proposal would clearly result in double taxation, it would fall far short of achieving the objective.

The "economic efficiency" objective is designed to encourage firms to "allocate resources to the most productive investments without regard to tax considerations . . . in a new national context, economic efficiency dictates that U.S. firms should not be influenced by tax considerations to invest abroad, when a domestic investment would otherwise be more productive. Conversely, when non-tax factors would otherwise favor a foreign investment (e.g., to better serve a foreign market), tax considerations should not discourage that investment or lead an investor to choose one foreign country over another. For example, to promote efficiency, our tax rules seek to avoid double taxation (U.S. and foreign) of foreign source income." (id.) Judged by this criteria, the proposal would surely promote inefficiency, since its very objective would be to impose double taxation on foreign source income.

The ability of U.S. firms to compete successfully with foreign firms in the international markets would be severely hampered by the proposal. It would make them uncompetitive. U.S. taxpayers, because of the U.S. tax system, would be placed at a disadvantage relative to their foreign competitors in foreign markets. Foreign competitors would be taxed only once on income subjected to tax in the host country market, whereas U.S. taxpayers would be subjected to an additional U.S. tax burden, thereby rendering them uncompetitive. The lack of competitiveness of U.S. firms would become evident immediately. Even a casual student of economics can observe that in order for U.S. taxpayers to maintain the same level of profitability of their foreign counterparts not subjected to the additional tax burden caused by the lack of a foreign tax credit, they must either increase prices of goods and services marketed in the host country (thereby rendering them uncompetitive with their foreign counterparts) or suffer a decrease in profitability for participation in the host country market (thereby rendering them uncompetitive with their foreign counterparts).

Conclusion

For the reasons discussed above, we believe the proposal to be ill-advised. Rather than placing additional burdens on U.S. taxpayers, we believe that Congress should address existing deficiencies in the foreign tax credit system to permit U.S. companies to compete more effectively. In particular, we believe there is no sound basis for the continuation of Code section 907. The objective of limiting foreign tax credits for extraction taxes paid to foreign governments has been achieved through regulations promulgated in the 1980's (Treas. Reg. §§1.901-2 and 1.903-1). Furthermore, there is no sound basis for treating income from refining and marketing operations differently than income from other manufacturing operations (Code sections 907(b) and 954(a)(5) and (g)). API believes that the policy implicit in the Omnibus Budget Reconciliation Act of 1993 to treat oil and gas taxpayers on a similar footing with other taxpayers should be furthered by repealing Code section 907 and abolishing distinctions between refining and marketing operations and other manufacturing operations.

Finally, denial of the foreign tax credit for AMT purposes should be abolished. The underlying rationale for AMT, to assure U.S. tax payments on economic income, is inappropriate with respect to foreign source economic income because the result is double taxation. The fact that there was no U.S. tax payment on economic income from a foreign source does not mean it was untaxed. While the AMT generally envisions acceleration of tax payments which otherwise will become due in the future (deferred because of preferences), the availability of foreign tax credits reflects that appropriate taxes are already being paid by a particular taxpayer to a foreign taxing jurisdiction. There is no economic income which escapes taxation. The limitation on foreign tax credits in the AMT should, accordingly, be repealed.

A proposal based upon a provision in H.R. 5270, as introduced in the 102d Congress, to modify the method by which income from the sale of inventory property is sourced.

The longevity of the title passage rule for inventory sales as a feature of the U.S. tax system is only slightly shorter than that of the foreign tax credit. It dates from the Revenue Act of 1921. (section 217(e), 42 Stat. 244). The proposal, which appears to be based upon section 203, of H.R. 5270, would further undercut this basic rule.

Section 203 of H.R. 5270 would have modified current sourcing rules in respect of U.S. residents' foreign sales of inventory manufactured in the U.S. and in respect of direct and indirect sales of inventory to U.S. residents.

Inventory sourcing was seriously considered in 1986 by Congress. It was then decided to retain the title transfer and apportionment rules of Code sections 861-863 for inventory sales. Congress was concerned that repeal of the title transfer rule in favor of a residency rule

> for sales of inventory would create difficulties for U.S. business competing in international commerce. Moreover, with the substantial trade deficits of the United States, Congress did not want to impose any obstacles that might exacerbate problems of U.S. competitiveness abroad.

At the same time, Congress directed the Treasury Department to study the source rules. In its study in January of 1993, the Department of Treasury concluded, among other things, that U.S. exporters with excess foreign tax credits in the general limitation category would export more under the source rules when such exporters locate investment in the United States and export to foreign customers. (See Report to the Congress on the Sales Source Rules, Dept. of Treasury, January 1993, at page 13.) In short, the Treasury Department study confirmed the suspicions of Congress in 1986 that alteration of the inventory source rules would diminish the ability of U.S. taxpayers to compete in international markets. Moreover, location of investment in the United States and exports to foreign countries are precisely the kind of activity which Congress ought to encourage, not discourage.

For these reasons, API cannot support the proposed alterations in the inventory source rules.

A bill (H.R. 220) to reinstate the tax on interest received by foreigners on certain portfolio investments.

In the Deficit Reduction Act of 1984 (PL 98-369) Congress generally repealed the 30% withholding tax on interest paid by U.S. borrowers on certain portfolio investments where the interest was received by a non-resident alien individual or foreign corporation. In making this change:

> Congress believed it important that U.S. businesses have access to the Eurobond market as a source of capital. Congress believed that the imposition of a withholding tax on portfolio interest paid on debt obligations issued by U.S. persons might impair the ability of U.S. corporations to raise capital in the Eurobond market. International bond issues are often exempt from withholding taxes and estate taxes imposed by foreign governments. By contrast, under prior law, U.S. bond issues generally were not exempt from the U.S. withholding tax although, as indicated above, a patchwork of statutory exceptions to the withholding tax existed, and the tax was frequently reduced or eliminated by treaty." (General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, December 31, 1984, JCS 41-84, at page 391)

Today, as in 1984, continued direct, unimpeded access to the Eurobond and other capital markets without the imposition of withholding tax on interest is of paramount importance. The ability of U.S. taxpayers to raise capital through the debt markets in the most economically efficient manner should not be discouraged. Efficient capital markets insure lower interest rates for all borrowers, including the United States government itself.

API knows of no sound basis for reimposition of withholding tax on portfolio interest. Any revenue gained by such a short-sighted policy would be short-lived.

Before the

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

September 27, 1993
Washington, DC

Statement Submitted by the

AMERICAN TRUCKING ASSOCIATIONS, INC.

on

MISCELLANEOUS TAX PROPOSALS

These comments represent the views of more than 34,000 trucking companies and suppliers that belong to the American Trucking Associations (ATA) or its 51 state and 10 national affiliated organizations.

ATA testified to the full Ways and Means Committee last March that the trucking industry would not oppose taxes that met President Clinton's call for "shared sacrifice," but that trucking should not have to pay an undue share of tax increases. Unfortunately, the final reconciliation bill did impose harsh burdens on trucking companies and drivers:

- a 4.3-cent-per-gallon fuel tax increase that takes effect October 1, 1993, the same day that truckers must begin using low-sulfur diesel that will cost several cents per gallon more than existing fuel;
- a cutback from 80% to 50% in the meal deduction, which strikes hardest at long-haul drivers who eat nearly every meal away from home;
- an assortment of tax-rate increases, deduction cutbacks and additional compliance expenses that will nick carriers unevenly and unfairly.

A number of the proposals before this subcommittee would continue this pattern of hurting business and individual taxpayers in unreasonable and often unintended fashions. Some of the proposals appear to be designed to pay for earlier "rifle-shot" tax breaks. But the trucking industry did not seek any of those breaks and it should not have to pay the price for others.

Our comments on specific provisions follow.

Increase the tariff on imported crude oil by 15 cents per barrel and refined petroleum products by 1 cent per gallon. **ATA strenuously opposes this tax.** There is no justification for any further tax on petroleum products. Furthermore, differentiating between imported refined products (1 cent per gallon or 42 cents per barrel), imported crude oil (15 cents per barrel) and domestic petroleum (no tax) will create windfalls for the domestic oil industry at the expense of truckers and other users, who will have to pay the higher price on all products.

Increase the "heavy truck chassis tax" from 12% to 12.1%. **ATA opposes this change.** The present 12% tax on highway tractors, heavy trucks and trailers was adopted in 1982 as part of a complex balancing of several taxes to spread highway tax burdens among different classes of users. Over the next few years, a comprehensive review of highway taxation may be warranted. But hiking the tax rate on several hundred thousand vehicles a year bought after a certain date is not warranted, either for general revenue purposes or to offset a limited break.

Require written substantiation of any meal or entertainment expense claimed as a business deduction, or of expenses over $10. **ATA opposes these suggestions.** They would hit especially hard at long-haul truck drivers, who may incur as many as 1000 small meal expenses in a year (plus innumerable cups of coffee and snacks from vending machines for which receipts are impossible). It is not reasonable from either a taxpayer's or an IRS auditor's standpoint to require retention of records from these purchases. It is bad enough that 50% of these modest, necessary meal costs will be disallowed, beginning in 1994; disallowing the remainder because receipts aren't retained would be outrageous. Meanwhile, larger expenditures for meals and entertainment would be unaffected, since substantiation is already required for them.

Clarify the treatment of environmental remediation costs by specifying the types of such costs that must be capitalized or requiring that all such costs be amortized over a uniform period of years; deny deductions for certain oil spill and hazardous waste cleanup expenses. **ATA believes current law is sufficiently clear and opposes changes that would make the law more complex or punitive.** We recently prepared detailed comments on the proper tax treatment of various types of environmental cleanup costs. We have shared these comments with Committee staff and would be happy to provide a copy to any Members who wish one.

Remove bakery products distributors from statutory employee status; repeal the safe haven under section 530 of the Revenue Act of 1978 for construction employers. ATA presented detailed testimony (copy attached) at the Subcommittee's July 23, 1992 hearing on independent contractor tax issues, as did two dozen other witnesses. We do not have a position on these particular proposals but believe there are many other issues equally deserving of attention.

Impose an excise tax on carbon dioxide sales by ethanol producers at a rate which would offset the current ethanol tax subsidies. ATA believes all highway users should contribute fairly to the Highway Trust Fund. The existing reduction in the Highway Trust Fund tax for ethanol violates this principle. Either the exemption should be abolished or the revenue should be replaced, for instance by placing revenue from this proposed tax in the Highway Trust Fund.

Freeze the business mileage deduction for a year, then round it down to the nearest cent; eliminate the deduction for the first 10 miles of trips beginning from home. **ATA opposes these changes.** They would add complexity, create audit disputes and discriminate against certain sales personnel and drivers.

Tax at a 30% rate the lobbying expenditures of tax-exempt organizations. **ATA opposes this proposal.** In light of the new disallowance of deductions of lobbying expense, this provision is clearly overkill. Furthermore, it discriminates against small businesses, which cannot afford their own lobbyists but rely on trade associations to represent them.

In addition, ATA opposes the following proposals, which would unevenly affect selected trucking businesses and workers and are unjustified deviations from reasonable tax policy. The proposals are listed in the same order as in the subcommittee's hearing announcements. Because the provisions do not appear to affect trucking uniquely, specific comments are omitted.

- requiring that a portion of advertising expenses be capitalized and amortized over a period of years;

- denying a business deduction for travel expenses in excess of the amount of coach fare;
- replacing the foreign tax credit with a deduction;
- increasing the excise tax on foreign reinsurance premiums;
- increasing the safe-harbor estimated tax level for high-income individuals from 110% to 115% of prior year's tax;
- increasing the rate of interest, or denying the deduction for interest, on corporate tax underpayments.

In summary, the trucking industry has already borne a heavy share of tax increases enacted this year. The industry is also facing a regulatory "tax" in the form of a stiff increase in fuel costs as a result of a mandate to use only low-sulfur diesel fuel, beginning October 1, 1993. The industry is in no position to bear further tax increases, particularly ones that would apply in a discriminatory fashion and do not provide substantial offsetting relief.

STATEMENT BY REP. JAMES H. BILBRAY
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE WAYS & MEANS COMMITTEE
SEPTEMBER 8, 1993

Mr. Chairman, I appreciate you giving me the opportunity to present my views on the proposed revenue raising measures aimed at paying for specific pieces of legislation pending before your Subcommittee.

Mr. Chairman, we have just gone through a difficult and painful budget process. While it is not the complete solution to our nation's deficit problem, it is a very important beginning. The package proposes more than 200 specific spending cuts totalling $250 billion. Under the plan, the taxation field is leveled by proposing revenue increases of $250 billion. All spending cuts and revenue increases are for deficit reduction.

However, the revenue raisers before you today will not be used to reduce the deficit. Instead, these gaming taxes will be used to pay for specific measures proposed by House Members.

The proposals that I am speaking about are:

--Increasing the withholding tax on winning bets of at least $5,000 from 28 percent to 36 percent.

--Raising the excise tax on wagers at sports books from .25 percent to 1 percent.

--Reducing the tax deduction for gambling losses from 100 percent to 80 percent.

The increase in withholding and excise taxes could generate about $120 million in additional federal tax revenues -- all at the cost to the gaming industry.

I have a problem with the federal government and this Congress singling out one industry. The gaming industry already pays among the highest taxes of any industry in the United States. In addition, gaming is the lifeblood in Nevada where gaming tax revenues provide the State with the funds needed to provide essential services for its citizens such as the police, education, and fire departments.

Also, I am deeply concerned that we are about to start a precedent of using the gaming industry as the cash cow for Member's special interests. The gaming industry in Nevada already pays its fair share and should not be abused in order to help one special group.

Finally, these tax proposals have been considered by Congress in the past and have been defeated. Last year, efforts were under way to raise the excise tax on sports bets from .25 percent to 1 percent to pay for a tax break for utility companies. The increase was dropped after strong and serious objections.

Mr. Chairman, I urge you during your deliberations to dismiss these tax proposals as possible revenue raisers.

NEWS BULLETIN

RICHARD BRYAN

UNITED STATES SENATOR
STATE OF NEVADA
103RD CONGRESS

Statement of Senator Richard Bryan
House Ways and Means Committee
September 21, 1993

Mr. Chairman, I thank you for the opportunity to present testimony before the Subcommittee on several issues important to a major industry in Nevada. There are three proposals being considered by the Subcommittee during this series of hearings on miscellaneous revenue measures which will severely affect the gaming industry, the mainstay of the Nevada tourist economy.

The three proposals I am referring to are the proposals to limit the deductibility of gambling losses to 80% of that currently available, to increase the withholding on gambling winnings over $5,000 to 36%, and to quadruple the federal wagering excise tax on state authorized wagers from .25% to 1%. All three proposals will unfairly harm the Nevada gaming industry, and none of the proposals is based on sound tax policy.

The first proposal, to limit the deductibility of gambling losses to 80% of that currently available, unfairly targets one form of income offset — gambling losses — for unfavorable tax treatment. In fact, the deductibility of gambling losses is already severely limited — gambling losses can only be used to offset gambling winnings. Gambling losses can not be used to offset non-gambling income. The proposal before the Committee would have the result of applying income tax rates, designed to be levied against net income, against a certain percentage of gross gambling winnings, no matter what the losses a taxpayer may have accrued.

The second proposal, to increase mandatory withholding on gambling winnings from the current 28% to 36% is similarly unfair. Federal income tax withholding is designed to approximate the federal tax liability of taxpayers. Last year, the withholding rate for gambling winnings was increased to 28%, a change I opposed, but at least a rate in line with many taxpayers marginal tax rate. Even at 28%, withholding on gambling winnings is likely to be unfair, since withholding does not take into account the difference between gross and net income, and the many deductions and exemptions available to most taxpayers.

Increasing the withholding rate to 36% creates an even more unfair situation for taxpayers collecting gambling winnings. Establishing a withholding rate of 36% for gambling winnings severs any remaining connections between federal withholding and actual tax liability. To base withholding on the 36% income tax rate — a marginal rate paid by only the very highest income taxpayers — creates a completely inequitable situation for a gambler collecting winnings. Should this proposal be enacted, an individual collecting gambling winnings would be subject to withholding at a far higher rate than any other type of taxpayer, including ordinary wager earners, those receiving bonuses, or those subject to backup withholding. This is essence amounts to a withholding penalty applied arbitrarily and indiscriminately to anyone who chooses to gamble.

The tax policy implications of using increases in withholding for short term revenue increases is questionable, at best. While increasing withholding on gambling winnings will create a modest increase in revenue in the short term, it does not increase the tax liability of the affected taxpayers. Any increased revenue generated by this proposal will be illusory — another example of the blue smoke and mirrors the federal government has been justifiably criticized for in the past.

While it is difficult to put a dollar figure on the harm the above two proposals would cause to the gaming industry, they would clearly be significant. Treating the customers of any business in such an inequitable manner would necessarily impact the business's bottom line — the business of gaming is no exception.

The final gaming related proposal being considered by the Subcommittee would have a more direct effect on the gaming industry. This proposal would quadruple the wagering excise tax from .25% to 1%. As members of the Subcommittee may be aware, the wagering excise tax is assessed on a very small segment of the gaming industry, primarily sports books. For wagers placed in state authorized sports books, such as those in Nevada, the tax is .25%.

THIS RELEASE IS PRINTED ON RECYCLED PAPER

An analysis conducted by the Nevada Resort Association, and described in the NRA's testimony before this Subcommittee, shows the potentially harmful effect of a quadrupling of the wagering excise tax. In fact, Nevada's sports books are not very profitable operations, and many operate with very slim margins. Quadrupling the wagering excise tax would in almost all cases make the major sports books unprofitable.

Of course, the sports books could modify their operations to increase profitability by modifying the odds, changing the spreads, or increasing the "vig." Unfortunately, however, such tactics are unlikely to work. Gamblers have an alternative to legal sports books — illegal bookies. The illegal sports books pay no wagering excise tax — or for that matter, income tax, workers compensation, business tax, or myriad other expenses of legitimate businesses.

An increase in the wagering excise tax unfairly targets the gaming industry in a misguided attempt to raise revenue for some of the miscellaneous tax proposals being considered by this Subcommittee, and should be rejected.

Mr. Chairman, all three of these proposals would be harmful to a major industry in Nevada. This is not the first time the gaming industry has had to fight off attempts at unfair changes in the tax code. Last year, for example, the industry was threatened with a number of attempts to raise revenue, one of which, the increase in withholding on gambling winnings from 20% to 28%, eventually became law. This targeting of the gaming industry to pay the bill for completely unrelated tax breaks serving other interests is unjustified, particularly given the already high tax burden shouldered by the gaming industry.

The last round of tax increases hit the gaming industry particularly hard. In addition to the increase in the corporate tax rate, or the individual income tax rate for those gaming concerns filing as Subchapter S corporations, the gaming industry will be hard hit by the reduction in the business meal and entertainment deduction and the changes in spousal travel deductibility. In addition, the business credit for FICA taxes paid on tips, which I supported, only applies to food service employees, providing only limited relief for Nevada's casinos.

Mr. Chairman, in spite of the recent trend towards the spread of gaming, it is still a major industry in only a few jurisdictions. Perhaps this limited scope is part of the reason why in recent years gaming has been raised as a potentially easy target for revenue increases. Perhaps there is a lack of realization that gaming is a legitimate and legal business, and should be treated like any other business. Whatever the reason or motivation, I think it is fair to say that I, as well others in the Nevada delegation, will strongly oppose unfair taxes on gaming, and that targeting the gaming industry for inequitable tax treatment will not be uncontroversial.

Mr. Chairman, I urge you and the other members of the Subcommittee to reject these three unwise and unfair proposals.

R.L. Burt, CPA
15-G2 College Hwy., Red Rock Plaza
Southampton, MA 01073
(413) 527-4829

August 31, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Ms. Mays:

I would like to comment on several miscellaneous tax proposals about to be considered. Please submit them for the printed record of the hearing.

1. **Requirement of written substantiation of ANY meal or entertainment expense claimed as a business deduction, or alternatively of those exceeding $10.00.** This requirement would add needlessly to recordkeeping. Consider that the 50% deduction limitation and the $25.00 current substantiation requirement at a 28% tax rate would yield only a $3.50 tax benefit (25.00 X .50 X .28 = 3.50). Must we mandate further recordkeeping for a deduction worth about $4.00?

2. **Requirement that a portion of advertising expenses be capitalized and amortized over a period of years.** Most businesses must advertise continuously to maintain the volume of traffic and image desired. The "benefit" of advertising, except in rare cases, is short lived. Only through repetition is any resemblance of a long term benefit derived. Should a business be penalized for helping stimulate the economy through repeatedly spending advertising dollars? I think not.

3. **Limitation of the deduction for wagering losses to 80% of the amount otherwise deductible.** Unless this provision is intended to force moral beliefs on the public it makes no sense. Where someone loses $100 on one bet and wins $100 on a companion bet (ignoring the cost of the bet here) he is no better off economically. Why tax him? What happened to the wherewithal-to-pay concept?

4. **Denial of travel expenses while away from home in connection with holding or managing real property when it is not a taxpayer's principal business activity.** While I understand this is intended to curb perceived abuses, it has the potential of doing great injustice to many investors. Serious consideration should be given to selective denial, rather than blanket denial, in order to preserve the investment potential in real property.

Sincerely,

Richard L. Burt, CPA

CENTEX CORPORATION

September 10, 1993

Ms. Janice Mays
Chief Counsel and Staff Director
Committee on Ways and Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Re: Miscellaneous Revenue Issues

Dear Ms. Mays:

Even though there was no detail provided in the Miscellaneous Revenue Issues proposal, we believe it is necessary to comment.

POINTS ON SINGLE-FAMILY MORTGAGES

> The Financial Institutions proposals to tax points on single family mortgages when received is objectionable. If the mortgages are sold by the originator, the income is accelerated when such sale takes place. On the other hand, if the mortgages are retained by the originator, the income is taken in ratably over the life of the mortgage and certain costs to originate are deferred and amortized over the life of the mortgage. This results in the income and costs being properly matched. Of course, any acceleration of income for tax purposes increases the economic costs which are ultimately passed on to the consumer. A change such as the one suggested in the proposal could take many people out of the housing market.

ADVERTISING EXPENSES

> It is very hard to understand any rationale for capitalizing and amortizing advertising expenses. In our businesses, home building, what we sell and where we sell it are communicated to potential customers through very frequent advertising programs. We generally do not have the same property or product for sale week after week and, accordingly, are not creating a "brand label". In addition, in our business, we do not generate frequent repeat business. In summary, there are very few, if any, long term benefits derived from our advertising programs.

All of the proposals appear to require an inordinate amount of record keeping and lack any substantive basis or rationale for adopting such proposals.

Yours very truly

Richard C Harvey

Richard C. Harvey
Vice President - Tax

RCH/nb

STATEMENT
INDEPENDENT BANKERS ASSOCIATION OF AMERICA

ON TAX EXEMPT ENTITIES AND COMPLIANCE MATTERS

BEFORE THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS

SEPTEMBER 21, 1993

Mr. Chairman, Members of the Subcommittee: The Independent Bankers Association of America (IBAA) appreciates this opportunity to express its views on several items contained in the miscellaneous revenue agenda of this Subcommittee.

The IBAA represents approximately 6,000 of the nation's community banks, and is the only national association exclusively representing community banks. Many IBAA banks are located in small towns and rural areas. Most of our members have less than $100 million in assets, with the average being about $50 million. A $50 million bank would have about 25 full time employees.

Excise tax on lobbying

Our association strongly opposes the proposal of a 30 percent excise tax on lobbying expenditures, for several reasons:

- As a matter of tax policy, Congress has this year enacted new tax requirements as to non-deductibility of dues attributable to lobbying expenditures (Omnibus Budget Reconciliation Act of 1993, or "OBRA"). This statute also provides for a proxy tax at the highest corporate rate (35 percent in 1994) in lieu of and, in some situations, in addition to non-deductibility of dues-related income. While associations are in the course of complying with the OBRA provisions, IBAA is seriously concerned that imposition of a further 30 percent excise tax upon the same or related activity would cause major confusion, and would thus not in the interests of orderly tax administration.

- As a matter of general public policy, the additional burden on representation imposed by such a tax would discourage participation in national policy discussions by smaller associations, businesses and non-profit organizations.

- In the opinion of IBAA, such a tax would, over time, tilt the balance of access and input to federal decision making materially in favor of larger firms and more affluent individuals and organizations that are best able to afford the cost of representation in Washington, D.C.

Relationship to recently enacted lobbying provisions.

During the consideration of the lobbying tax provisions of the Omnibus Budget Reconciliation Act (Public Law 103-66), IBAA became aware of the House and Senate proposals lobbying tax proposals, attempted to provide constructive input at the Conference stage, and is now taking steps to bring our association and members into compliance with the law by the end of this year.

Since our association does not keep records on the basis of lobbying activities or legislative activities, this compliance process involves several steps: evaluation of the new requirements, analysis of association budgeting, billing, accounting and management information procedures, decisions on how to modify these systems, and implementation of these decisions by actually making the system changes and communicating with our membership as a basis for their actions.

Imposition of a further excise tax at the level of 30 percent, or at any level, with its own set of parameters, definitions, exceptions and relationships to the OBRA provisions,would, at this point, be complicating and burdensome, and in the nature of "piling on."

Taxing representational activities favors the wealthy

Beyond the compliance issues, there is a major public policy issue. Associations such as ours serve the banks that are smallest and follow public policy issues least. Banks with 25 employees seldom have full time accountants or attorneys; they certainly do not have full time public policy professionals.

Large corporations often have government relations offices in Washington to monitor legislative and executive branch activity for impact upon their significant financial interests. For such firms, the cost of Washington representation is a small fraction of their revenues.

There is evidence that representational organizations react to financial incentives and disincentives. During the past decade, associations have tended to locate in the suburban areas around Washington, D.C. to take advantage of lower costs and more conveniences of doing business in these locations ("Associations Packing Up, Moving Out," Washington Post, Sept. 13, 1993, Business Section, page 1). From 1984 through 1992, association locations in and around the Nation's Capital increased by the following percentages: Washington, D.C. +4.8 percent, Northern Virginia +16.2 percent, and Maryland +20.5 percent.

Similarly, associations, businesses, and non-profit organizations could be expected to react to higher costs of representation in the public policy process by reducing this activity. For example, a bank with $50 to $100 million in an assets and a 1 percent return on those assets would certainly weigh any additional cost of representation when deciding whether it wished to have input to policy deliberations.

We believe that further burdening the representation process would shift access in Washington and in the State Capitals against the interests of the smaller associations, non-profit groups, and thus great majority of medium-sized and smaller firms.

Information returns

Item 7 of the Committee's release raises the question of whether all financial institutions, rather than some categories as provided in current law, should distribute information on debt cancellation in excess of $600 to the U.S. government and to the debtor. IBAA favors this proposal.

Section 14232 of the Conference Agreement provides that certain financial institutions, such as banks will be subject to such requirements after December 31, 1993 and governmental agencies will begin to report following enactment of the statute. This imposes still another compliance project for banks, and will add to the burdens of smaller banks that constitute the bulk of this association's membership.

It is our understanding that the law codifies Treasury guidelines that have existed since 1984 that require U.S. government agencies to report forgiven debt on forms 1099-G. For example, if there is a workout by the RTC, or another government agency, and debt is reduced by more than $600, this would be reportable under the Treasury Guideline. The new section extends the obligation to certain financial institutions but not to others.

If some financial institutions must live with these requirements, it would seem logical that the same policies would apply generally to financial institutions that are similarly situated and involved in comparable transactions.

LBP

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September 7, 1993

Janice Mays
Chief Counsel and Staff Director
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Committee Members:

I have learned of the hearings to be held September 8 and 14 on miscellaneous tax proposals. I wish to argue against several of these proposals because of their complexity, the additional recordkeeping burden they would create, or their unfairness.

1. **Deny deduction for travel expense in excess of the amount of coach fare, if coach passage is available for the trip.** This would require verification and records showing that coach passage was unavailable. Travelers preferring or requiring non-coach passage (due to medical reasons, etc.) will attempt to circumvent these rules by scheduling travel on busier flights, smaller carriers, etc. It is important to remember that the full fare is income to the carrier.

2. **Limit business mileage deductions for trips beginning at taxpayer's home to mileage in excess of ten miles.** This will require additional records and calculations to show what amounts are in excess of ten miles and which trips started at home. The rules might be circumvented by making a one mile trip and then beginning the next trip from that point. It seems those most likely to be affected would be in small towns and cities where the distance from point A to point B will generally be less.

3. **Freeze the standard mileage rate for business use of an automobile at 28 cents per mile through 1994.** The rate has already stayed at 28 cents since 1992. You recently added to the cost of automobile travel by increasing the gas tax. Although the overall rate of inflation has been moderate, inflation still exists, particularly in automobile costs, local property tax rates, and the cost of repairs.

4. **Deny deduction for travel expenses while away from home in connection with holding or managing real property unless holding or managing real property is the taxpayer's principal business activity.** It seems this provision would be fairer if it included a mileage limit (perhaps travel beyond 500 or 1,000

miles would be affected) to prevent deductions for what may essentially be vacation trips. Even this would be unfair to persons who relocate for business reasons, but who are unable to sell property in their former location due to economic conditions, etc.

5. **Limit the deduction for wagering losses to 80% of the amount otherwise deductible.** This seems unfair since wagering losses for high income taxpayers may already be limited to 80% of the actual loss under the limit for itemized deductions. This provision would mean only 64% of the actual loss would be deductible in some cases. At the same time gambling winnings (against which the loss deduction is first measured) increase adjusted gross income used in calculating the 80% limitation on itemized deductions.

6. **Increase estimated tax payments under the safe harbor method to 115% of last year's tax liability for individuals with adjusted gross income over $150,000.** Many individuals, particularly those who are self-employed or are investors, have limited knowledge of their true tax situation until late in the year. My idea of a safe harbor is something relatively painless, yet the higher percentage will force many to choose between a possible interest free loan to the government, if the safe harbor payments exceed their actual tax, or the added expense of multiple income tax estimates to determine their actual tax liability. As the tax system continues to become more complex, this cost increases.

   This provision might be palatable if coupled with a provision paying interest to the taxpayer for any overpayment in excess of 100% or 110% of the prior year's liability. Without such a provision I can envision the percentage increasing to 150%, 200%, or even 300% in order to raise revenues.

7. **Require written substantiation of any meal or entertainment expense claimed as a business deduction; alternatively, require written substantiation of any meal or entertainment expense in excess of $10.** The deduction has already been limited to 50% of actual. This provision would require additional recordkeeping for the written substantiation, and in many cases additional restaurant staff time to prepare receipts not presently required for such low cost meals. Reimbursements or per diems to Federal employees should be directly related to the allowable 50% deduction.

8. **Increase the rate of withholding on bonuses from 28% to 36%...Increase the rate of backup withholding from 31% to 36%...Increase the rate of withholding on gambling winnings from 28% to 36%.** While a uniform withholding rate seem advisable, I believe the 36% rate is too high. Your own figures will show that the individuals subject to the 36% or higher rates (single taxable income > $115,000, married filing jointly taxable income > $140,000) are a small percentage of the taxpaying population. In addition, many of these will now be subject to the Alternative Minimum Tax at a maximum rate of 28%.

   I believe these withholding rates should be maintained at their present levels since many more individuals would be subject to these rates than those actually subject to the 31% or higher rates. Raising the rates takes a great deal more from the individual in the 28% tax bracket which they will not have refunded until filing their tax return.

9. **Require that a portion of advertising expenses be capitalized and amortized over a period of years.** This provision cuts the heart out of the entire concept of "ordinary and necessary" expenses being a current cost of business. Instead you begin to shift the deduction to later periods based on arbitrarily determined lives or very subjective determinations. Since the intent is clearly to accelerate revenue collections you should "call a spade a spade" and raise the tax rates further (for all taxpayers to see) instead of camouflaging the increase in this way. Again, I can envision a not to distant future when all deductions are subject to this type of provision, or worse.

I do support the provision which would require taxpayers to include in income the rental income received with respect to the rental of a residence without regard to the period of the rental. I believe this is only fair. When there is an actual monetary benefit, in the form of cash received, the income should be taxed. Of course, taxing this income should allow deduction of related expenses for the rental period.

I ask you to strongly consider these points during your hearings and beyond. It is time for Congress to shoulder the burden of reducing spending instead of taxpayers shouldering the burdens of more "red tape" and increased complexity of the tax system.

Sincerely,

LARSEN, BRYANT & PORTER, CPA'S, P.C.

Brent L. Stehlik, C.P.A.

BLS/amb

NASE™
National Association for the Self-Employed
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"Serving the Needs of Small-Business America"

STATEMENT

September 23, 1993

The Honorable Charles B. Rangel
Chairman
Subcommittee on Select Revenues
Committee on Ways and Means
1102 Longworth House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

The National Association for the Self-Employed (NASE) is pleased to submit this letter for consideration by the Subcommittee on Select Revenue Measures regarding the September 1993 hearings on miscellaneous revenue measures. I respectfully request that the NASE's letter be inserted as part of the record for these very important hearings. The NASE represents over 320,000 small business persons from throughout the United States. Over 85 percent of the NASE members are business owners with 5 or fewer employees. The membership is involved with a very wide range of businesses, notably in the consulting services and retail fields. The letter provides comments on the issues regarding the automobile mileage deduction, certain travel expenses, the meals and entertainment deduction, and independent contractors.

Proposals To Restrict or Limit the Standard Mileage Rate and Business Mileage Deduction

The NASE is very concerned about any proposals to freeze the standard mileage rate or to place limits on the business mileage deduction. We view these kinds of proposals as striking at the very core of the potential for success or profitability for a small business.

The deduction for automobile expenses is very important to a broad range of types of self-employed persons. For example, it is important to a retailer who prides himself on timely delivery of merchandise to a customer. Another example as to significance of the deduction is with respect to the independent sales person who uses his car to visit customers.

Under current law, there are two ways to compute the business deduction for automobile expenses. The first method is to calculate the actual expenses allocable to business use of the automobile. The second method is called the standard rate method, under which the automobile expense is calculated by multiplying the total number of miles the automobile is used for business purposes times the standard mileage rate.

Particularly in light of the significant tax increases levied on self-employed persons by the 1993 Budget Reconciliation Act, the NASE expresses strong concerns about the levying of any further tax increases on the small business community -- the sector of the economy that generates a large proportion of the jobs for the American work force.

Business Deduction for Travel Expenses

The Subcommittee on Select Revenues is considering a proposal to deny a business deduction for travel expenses in excess of the amount of coach fare if coach passage is available for the trip. The NASE believes that enactment of this proposal would likely create a compliance nightmare for small business.

The NASE believes that this proposal would create onerous recordkeeping burdens for a number of reasons. With the wide variety of pricing structures and fare discounts, a business person is likely to find it very difficult to determine what constitutes a coach fare. For example, airline A (considered a deep discount carrier) charges $400 for a round trip "first-class" ticket to Atlanta, while airline B charges $450 for a round trip "coach" fare to the same city. The NASE does not believe a taxpayer should lose a tax deduction for saving money by flying airline A (under this example) even though he might have otherwise been able to obtain a coach seat on airline B.

Arguably, the taxpayer would not be entitled to any tax deduction for his travel expenses under this proposal unless he would agree to maintain logs detailing the number of airlines flying to Atlanta and their extensive, ever-changing pricing structures. The NASE views this kind of recordkeeping as a clear detraction from the productive, economic efforts of one's business. We also believe that this proposal can arguably be called a form of "price controls", a situation which will also do little to encourage taxpayers to make productive, economic decisions.

Meals and Entertainment Deduction

The NASE strongly opposes the provision contained in the 1993 Budget Reconciliation Act which reduces the business meals and entertainment deduction from 80 percent to 50 percent. By the same token, this association also opposes the compliance proposal before the Subcommittee which would have the net effect of further restricting the meals and entertainment deduction. This proposal would tighten the rules relating to written substantiation of meal and entertainment expenses.

The business meals and entertainment deduction is very important to the nation's small business community. While large companies are able to advertise for customers in national newspapers and on television and radio, small business persons often find that the only way for them to solicit or retain customers is over a business meal. It is a critical and necessary form of advertising for the self-employed.

The NASE believes further restrictions on the meals and entertainment deduction will have a negative impact on small business. Instead of considering further ways to restrict this vital deduction for small business, Congress should take steps to restore the deduction to the 80 percent level -- or better yet, to the more equitable level of 100 percent.

Independent Contractors

The Subcommittee on Select Revenues is considering a proposal which could have the effect of eliminating the use of independent contractors as workers in the construction industry. The NASE is generally opposed to proposals of this kind. As a general principle, we believe Congress should be taking steps to foster independent contractor status and entrepreneurship within the U.S. economy, as opposed to taking steps to restrict such status.

It is ironic that this very subcommittee recently received testimony involving a proposal to extend independent contractor status to certain workers in the bakery industry. Now, it is considering a measure to restrict the use of independent contractors in the construction trade. This is a clear indication of just how uncertain the tax law is regarding independent contractor status.

Under current law, a worker is classified as an employee or an independent contractor based on an analysis of 20 common law factors. This 20 factor test is grounded in medieval-age tort law concepts involving master-servant relationships. The underlying premise of the 20 factor test is based on the degree to which a company controls the work of the service provider.

To the extent a business has misclassified a worker as an independent contractor, the misclassification is likely to have been inadvertent and a result largely due to the fact the 20 factor test is vague and difficult to interpret.

As we stated in a recent letter to the subcommittee during the June 1993 hearings on miscellaneous revenue measures, the NASE urges the House Ways and Means Committee to take steps to foster and promote independent contractor status. Vigorous promotion of the independent contractor status is necessary for the preservation of the nation's entrepreneurial base. We believe this can be accomplished by drafting legislation to clarify the 20 factor test and the treatment of independent contractors under the tax law.

The NASE appreciates the opportunity to provide the Subcommittee with organization's views on the above miscellaneous revenue proposals. We look forward to working with The Subcommittee on these and other issues of importance to the nation's small business community.

Sincerely yours,

Bennie L. Thayer

Bennie L. Thayer
Chairman/CEO

National Association of Convenience Stores

I. IDENTITY OF NACS

The National Association of Convenience Stores ("NACS") is an international trade association composed of over 1,400 retail member companies. The convenience store industry is the fastest growing segment of the food retailing, and well as gasoline marketing, business. Today, there are more than 71,000 convenience stores with approximately half a million employees.

The convenience store industry has its roots firmly planted in the small business community. While there are large, national and regional chains among NACS' members, almost 60 percent of the member companies have fewer than 10 stores. Thus, the convenience store industry is particularly affected by legislation affecting small businesses.

II. TAX-EXEMPT ENTITIES

A proposal to impose a 30-percent excise tax on expenditures of tax-exempt organizations for lobbying (including amounts paid as salaries and an allocable portion of support costs).

NACS strongly opposes the imposition of an excise tax on expenditures of tax-exempt organizations for lobbying. Tax-exempt organizations other than public charities (Section 501(c)(3) organizations) have been substantially affected by the new provision in the Omnibus Budget Reconciliation Act of 1993 ("Act") that disallows a deduction for lobbying expenses. Under this new provision, lobbying expenditures must either be paid with nondeductible dues or are subject to a 35-percent proxy tax. To add the 30-percent excise tax to the new provision essentially would be to tax lobbying activities of tax-exempt organizations out of existence.

The new provision in the Act disallows a deduction for lobbying expenses whether those expenses are paid directly by the taxpayer or indirectly through dues to a tax-exempt organization. In lieu of disallowing a deduction for dues, the provision allows dues to remain fully deductible provided the tax-exempt organization pays a proxy tax. This eliminates any tax subsidy for lobbying activities. If a 30-percent excise tax is imposed in addition to the new provision, the net effect would be a direct tax on lobbying activities. While it may be permissible to disallow a deduction for exercising a First Amendment Constitutional right, it is impermissible to directly tax the exercise of that right.

III. COMPLIANCE PROPOSALS

A. Interest on Corporate Tax Liabilities

A proposal to deny corporations a deduction for all (or part) of interest paid to the Internal Revenue Service on tax underpayments.

A proposal to increase the rate of interest payable on corporate tax delinquencies.

NACS strongly opposes any proposal to alter the tax treatment of interest paid by corporations on tax underpayments or delinquencies. The Internal Revenue Code of 1986 ("Code") contains numerous penalties that may be imposed on corporations that incorrectly report and pay their income and other taxes. These penalties are designed to ensure compliance.

Interest is not a penalty; it is a charge for the use of money. Interest should be the same whether it is the Government using the money (*i.e.*, a refund situation) or it is the taxpayer using the money (*i.e.*, a deficiency). Similarly, it should be the same whether the taxpayer is an individual or a corporation. To impose a higher interest rate on one class of persons in situations in which risk of payment is not an issue unfairly discriminates against that class.

To be sure, Section 6621 of the Code already discriminates on the imposition of interest. It unfairly favors the Government over taxpayers and further discriminates against large corporations. This recent discriminatory approach is simply bad tax policy and should be repealed. Moreover, this discriminatory approach should not be made worse by further discriminating against corporations.

Besides being bad tax policy, discriminating against corporations further implicates Federal tax considerations in selecting the form of doing business. Recent Congressional efforts have been to reduce tax consideration in selection the form of doing business. Congress should not move forward with proposals that contradict this effort.

B. Tax Withholding

A proposal to increase the rate of withholding on bonuses from 28 percent to 36 percent.

A proposal to increase the rate of withholding on gambling winnings from 28 percent to 36 percent.

A proposal to increase the rate of backup withholding from 31 percent to 36 percent.

NACS supports the proposals to increase the rate of withholding on bonuses and gambling winnings and the proposal to increase the rate of backup withholding. Experience demonstrates that the best way to ensure compliance with the tax laws is to have withholding at the source. Better compliance means more revenue without increasing the tax burdens on other taxpayers. Increasing the withholding rate to the highest marginal tax rate will mean that few taxpayers will owe additional taxes on bonuses, gambling winnings, and amounts subject to backup withholding. This substantially reduces the likelihood that taxpayers will have insufficient funds to pay taxes and that the Government will have to pursue the taxpayer for additional taxes on this income. (There may be situations in which taxpayers subject to withholding under these provisions are also subject to the 10-percent surtax, but these will be limited.)

C. Miscellaneous Issues

A proposal to disallow deductions for compensatory damages under certain environmental laws.

NACS strongly opposes any proposal to disallow a deduction for compensatory damages under environmental laws. Many NACS members market petroleum products; primarily gasoline. The petroleum products are usually stored in underground storage tanks. The petroleum products stored in these tanks sometimes leak into the surrounding soil and groundwater. The leak can be a result of a hole in the tank or a leak in the pipes that connect the tank with the dispensing equipment (*i.e.*, the gas pump). In situations in which the leak contaminates another persons property, the taxpayer may be required to pay compensatory damages.

The payment of compensatory damages is not intended to penalize the person responsible for the contamination; rather, it is to compensate the person who has been damaged as a result of the contamination. A taxpayer may be liable for compensatory damages even though it was responsible and careful in the handling of the petroleum products.

If a taxpayer is negligent in the handling of petroleum products (or any environmentally sensitive material), it may be liable for a fine or penalty. It was established long ago that taxpayers can not claim a deduction for the payment of fines or penalties incurred in connection with their trade or business. To permit a deduction would frustrate public policy, because it would ameliorate the "punishment" imposed for wilfully, knowingly or negligently committing the specific act.

Liability for compensatory damages is not dependent on wilfully, knowingly or negligently committing a specific act. Rather, it is generally dependent on the simple fact that an act by one person has caused damage to another person. There is no "public policy" issue involved. To deny a deduction for any portion of compensator damages would cause such damages to be treated the same as fines and penalties. This would substantially increase the cost to the party making the payment, and, accordingly, tend to decrease the amount available to pay the damaged party. This would hinder, rather than promote, prompt, corrective action of environmental problems.

A proposal to clarify the treatment of environmental remediation costs by (1) specifying the types of such costs that must be capitalized, or, alternatively, (2) requiring that all such costs be amortized over a uniform period of years.

The tax treatment of environmental remediation costs is a major issue for NACS members. Many NACS members have incurred substantial costs in recent years to replace underground storage tanks and clean up the surrounding soil and groundwater. The tax treatment of remediation costs such as these is unclear.

NACS believes that costs incurred to clean up soil and groundwater owned by the taxpayer that was contaminated as a result of the taxpayer's business activities should be deductible. When a taxpayer incurs costs to return the soil and groundwater to their condition before the taxpayer's business activities contaminated them, the taxpayer is merely "repairing" them. The taxpayer is not increasing the value of the soil and groundwater over their original condition.

Requiring taxpayers to capitalize soil and groundwater remediation costs increases the cost of remediation. The tax laws should encourage, or, at a minimum, not discourage, taxpayers from engaging in remediation activities. Requiring taxpayers to capitalize these costs would discourage remediation activities by making them more expensive.

IV. CONCLUSION

NACS strongly opposes any additional taxes on the lobbying activities of tax-exempt organization, and believes that the 30-percent excise tax in addition to the new provision under the Act would be an unconstitutional tax on a First Amendment right.

NACS opposes any proposal that furthers the discrimination against corporations in connection with the imposition of interest on tax liabilities. NACS also opposes any proposal that treats compensatory damages under the environmental laws like fines and penalties by disallowing a deduction for the payment of such damages.

NACS supports efforts to improve compliance by increasing the rate for withholding on bonuses and gambling winnings, as well as increasing the rate for backup withholding. NACS also supports efforts to clarify the tax treatment of environmental remediation expenses, provided Congress develops rules that will encourage, rather than discourage, the clean up of the environment.

NACS would be pleased to answer any questions the Subcommittee may have. Written questions may be addressed to Marc N. Katz, Manager, Congressional Affairs, at the National Association of Convenience Stores, 1605 King Street, Alexandria, Virginia 22314. Mr. Katz may also be reached by telephone at (703) 684-3600.

September 14, 1993 Hearing
by
Committee on Ways and Means
Select Revenue Measures Subcommittee
House of Representatives

on

Miscellaneous Revenue Measures

by

James E Forrester, EA
on behalf of
The National Association of Enrolled Agents

Members of the National Association of Enrolled Agents are professional individuals whose primary expertise lies in the field of taxation. They have established this expertise by either passing a comprehensive, 2-day, examination on Federal taxation rules and regulations administrated by the Treasury Department, or by serving as employees on the Internal Revenue Service in an appropriate job classification for at least five years They maintain this level of expertise by completing at least 30 hours of continuing education each year.

We are representatives who serve a large cross-section of the taxpaying public, including individuals, sole proprietor businesses, partnerships, corporations and trusts We work with these entities to facilitate their complete and accurate reporting of tax information to the taxing authorities, and because of this are intimately familiar with the difficulties and frustrations associated with properly complying with our increasingly complex tax laws.

I am James E. Forrester, a partner in the firm of Draper, Forrester, and Associates, San Jose California. I have served as a member and Subcommittee Chair of Government Relations and Secretary of the National Association of Enrolled Agents.

Accounting

The proposal to lengthen the amortization of organizational expenses from a period of 5 years to 14 years seems to be working against the interests of the government. The country and the economy depends to a significant extent on the establishment of small businesses to foster growth and provide jobs for our growing population. Statistics indicate that most small businesses that fail, fail in the first five years. Statistics also indicate that the primary reason for failure of these small business is due to undercapitalization Requiring these companies to recover their cost of initiation over an extended period would tend to increase the possibility of failure because of increased tax burden during the critical early developmental years This in turn would tend to increase the unemployment roles due to increased business failures.

Small business people are people with a dream. They believe in the concept of "the better mousetrap". However, in this real world, in order to attract customers to your activity you MUST advertise. The cost of advertising has become increasingly expensive over the years. Requiring a small businessperson to amortize their advertising expenses over a period of years would add a double burden. First and foremost, as discussed above, this business needs every bit of working capital available to assure their continuing existence. Secondly, the additional burden of bookkeeping and accounting that would be added to the already overworked small business person might be the straw that breaks the camels back. Finally, for all but the largest businesses, advertising will initiate increased revenues within the immediate twelve month period or it is completely wasted. Consumers will respond to information presented to them immediately or not at all. To require the amortization of advertising expenses beyond the current year would tend to distort the match up of income and expenses and increase the immediate tax burden unfairly.

Individual Income Tax

The denial of travel expenses of owner/managers of rental property is grossly unfair to the individual taxpayer. An individual who is forced to rent his home while living in a different area to find work will incur necessary travel expenses to maintain the rental activity To deny this individual a deduction because he only owns one rental property is not equitable. Similarly, other individuals who for various reasons have decided to invest their capital in the real estate market rather than alternative investments should not be discriminated against as to the type of operational expenses they are allowed simply because they are a small investor

Congress has raised the tax on gasoline. To also freeze the standard milage rate at the 1993 rate seems to be doubling the tax burden. It is the small business individual who depends on the standard mileage rate. Again this proposal seems to be increasing the tax burden on that sector of the population that the country is depending upon to stimulate the economy and assure a continued rise out of recession. This seems to be diametrically opposed to the stated position of Congress and the current administration.

The business mileage limitation proposal seems to also target the very small businessman. The recordkeeping burden alone would add to the taxpayers problems Should he record each trip or only the trips he knows will be in excess of 10 miles Many real estate agents do not travel beyond a 10 mile radius on any single trip when showing houses to their clients, yet they easily expend 15,000 to 20,000 miles each year.
The IRS also would find this provision difficult to administer. It is reasonably straightforward to establish the business activity trips and personal activity trips. However, if an auditor was also required to establish the distance of each trip to determine its deductibility, the time required to do the examination properly would be prohibitive.

The small business person is in business to make money. Because of this he of she will travel long hours to attend meetings with customers anywhere that makes business sense. To limit the deductibility of those travel costs seems unwarranted. If coach fare is available, the astute business person will take it unless there is a sound business reason for flying some other class. If an individual is flying on the "red-eye" to make a meeting in the early morning it might make very good business sense to fly business or even first class to take advantage of the additional room available in these areas. The additional cost incurred is a business decision and the tax savings on this cost is only a fraction of the out of pocket cost. The small business person lets "the bottom line" dictate the cost of their travel.
The IRS would find this proposal extremely difficult to administrate. The availability of coach fare is a variable which changes constantly as a commuting flight is being made up. It would seem to be impossible to determine, after-the fact, if coach fare was or was not available. As a matter of fact, when making reservations, there are times when first class is purported to be all that is available, yet when the flight leaves there is space in coach because some coach reservation was cancelled.

Personal casualty losses already have the dual floor of $100 and 10% of AGI. To increase the floor from $100 to $500 seems unwarranted . If an individual has a casualty such that he exceeds the 10% of AGI threshold, he will need all the help and support the government can provide.

Compliance

The proposal to require written substantiation of all meal and entertainment expenses or in the alternative all expenses in excess of $10 00 is again increasing the paperwork burden of the small business taxpayer. In the normal course of events, the business person will charge or otherwise substantiate a meal expense in excess of $25.00 However, the cost of our daily living being what it is, buying a hotdog, a bag of chips, and a diet soda for two people costs more than $10.00. Keeping cash receipts of this nature is difficult, time consuming and frustrating. It detracts from the small business person's primary purpose--making the business grow and prosper. The current system seems quite workable and should be retained.

The National Association of Enrolled Agents strongly supports the proposal to establish an on-line capability for payers to verify Taxpayer Identification Numbers (TINs). One of the increasingly difficult areas of compliance for the small business person is the preparation and submittal of correct Forms 1099 and W-2. A primary area of difficulty is verifying the correctness of the TIN given to the payor and the complexity of instituting a backup withholding when the TIN is not correct. This proposal would permit the small business individual to quickly determine if the information they received from their contractor or employee is correct. This proposal could significantly reduce the compliance burden to the small business taxpayer.

Concluding Comments

The small business taxpayer is the backbone of our economic system. If more and more laws are passed which increase the difficulty in the achievment of their goals they will be increasingly tempted to find ways around the rules rather than complying with them.

Enrolled agents are involved with taxpayers in every aspect of their interaction with our tax system. We believe that all taxpayers should comply with the tax laws because that is the only fair way to spread the burden of support equitably over all citizens. We have found that the taxpaying public has become increasingly frustrated as they continue to face complex tax laws that are difficult to understand and comply with. We applaud your efforts in the past to increase the simplicity and maintain the consistency of our tax laws. We support your efforts in this area wholeheartedly.

Thank you for the opportunity to submit this information for your review. We would be very pleased to respond to any requests for additional input on tax matters.

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
submitted to the
HOUSE WAYS AND MEANS COMMITTEE
SUBCOMMITTEE ON SELECT REVENUE MEASURES

September 23, 1993

The NATIONAL ASSOCIATION OF REALTORS® (NAR) appreciates the opportunity to submit written comments to the Select Revenue Measures Subcommittee concerning several revenue-raising provisions described in Subcommittee Press Releases Nos. 9 and 10. The provisions on which we wish to comment are as follows:

1. A proposal to amend the like-kind exchanges rules to require that the Code section 1031 property received must be "similar or related in service or use" to the property exchanged, except in the case of condemnations.

2. A proposal to require that a portion of advertising expenses be capitalized and amortized over a period of years.

3. A proposal to repeal the safe harbor under section 530 of the Revenue Act of 1978 (relating to the classification of workers as independent contractors) for construction industry employers.

4. A proposal to clarify the treatment of environmental remediation costs by (1) specifying the types of such costs that must be capitalized, or, alternatively, (2) requiring that all such costs be amortized over a uniform period of years.

5. A proposal to impose a 30-percent excise tax on expenditures of tax-exempt organizations for lobbying (including amounts paid as salaries and an allocable portion of support costs).

6. A proposal to deny certain deductions for travel expenses paid or incurred while away from home in connection with holding or managing real property unless holding and managing real property is the taxpayer's principal business activity.

7. A proposal to freeze the standard mileage rate used to determine deductible automobile expenses . . . and [a] proposal to limit the business mileage deduction for trips beginning at the taxpayer's home to mileage in excess of 10 miles.

1. LIKE-KIND EXCHANGES

In 1987 and 1989, Congress contemplated restrictions on like-kind exchanges. All proposals were defeated, because Congress correctly understood that restricting these transactions would have an adverse impact on many markets, and would make it all but impossible for many owners of real estate to use their properties to full advantage. Since then, many real estate markets have lost as much as 30 percent of their value, and the real estate market is significantly depressed. Thus, it is imperative that Congress do nothing to further jeopardize those markets. **Any attempt to limit the like-kind exchange rules would be imprudent, and would be vigorously opposed by the entire real estate industry.**

The Subcommittee proposes changes that would replace the "of a like kind" test of current law with a requirement that exchanged properties be "similar or related in service or use." Substantial bodies of case law define both of those terms. Changing the application of that law would be unfair, and would add complexity to real estate transactions. We oppose any change that would narrow the application of current law. We urge the Subcommittee to reject any change for the following reasons:

No cash is generated to pay taxes. The taxpayer has no access to cash at any point until all facets of an exchange transaction are consummated. Thus, the transaction generates no funds to pay any tax that may be incurred. Current law already requires the parties to an exchange to pay taxes on any cash or nonlike-kind property received in the exchange. Requiring immediate tax payments that exceed the cash received from the transaction is inherently unreasonable.

Restricting like-kind exchanges will "lock in" real estate investments. Like-kind exchanges are often used when owners need to dispose of property but are unable to pay the tax that an outright sale would generate. In many instances, and despite declining property values, any gain that is subject to tax is attributable to inflation. Rather than pay tax on inflationary gains at ordinary income rates, many real estate investors and entrepreneurs simply hold on to their investments. Adoption of the proposal under consideration would significantly add to the "lock in" effect of real estate investments, and would reduce real estate activity in the marketplace.

Tax liability is deferred, but not avoided, under the current like-kind rules. Tax on a like-kind exchange of investment or income-producing property is not permanently avoided, but only deferred until an ultimate sale of the real estate investment occurs. Upon a subsequent disposition of the property, the deferred tax liability becomes due and payable.

Taxation of like-kind exchanges of real estate is inappropriate because taxpayers maintain continuity of their real estate investment. Congress authorized nonrecognition of gain on like-kind exchanges in 1924. It did so primarily because a taxpayer should not incur a tax when he continues his investment in like-kind property through an exchange of investment or income-producing real estate. A continuity of business interest shows that the parties have not changed their economic position. As there is no change in economic position, there should be no tax.

Proposals to restrict like-kind exchanges would raise little or no revenue. While the revenue estimates for proposed restrictions to the tax-deferred, like-kind exchange rules for real estate have been estimated to generate significant revenue, those estimates are based on the assumption that these transactions will continue unabated even with the new restrictions. This assumption is clearly erroneous. Most like-kind exchanges of investment or income-producing real estate would not occur if the transactions were subject to tax.

Congress has shown no evidence of abusive transactions. Current law is nonabusive and should be maintained. The current rules allowing nonrecognition of tax in a like-kind exchange exist because a taxpayer who exchanges like-kind property has not altered the level of investment and therefore the economic position of the taxpayer has not changed. These rules have worked well for over 60 years and their flexibility has helped to enable productive exchanges to occur. These range from exchanges of single-family rental homes to large multi-user rental properties, and from farm or ranch property to large unimproved tracts of real property. The rules have helped park management programs obtain unimproved property adjacent to parks by offering developed property in exchange. Farmers and ranchers, otherwise faced with excessive capital gains taxes, have retired and exchanged their farm or ranch property for property that could provide retirement income. Many of these beneficial transactions would be curtailed under the Subcommittee proposals.

The House-proposed similar or related in use standard should be rejected. It represents a significant narrowing of the types of exchanges that will qualify under Section 1031 and produces results which are simply unfair to taxpayers. The House-proposed standard clearly disallows exchanges of raw land for developed real estate. The similar use standard would also produce a rule that is administratively more complex, depending on whether the taxpayer is an owner who uses the property in a trade or business, or an owner who leases the property and holds it for investment. This adds compliance burdens to the Internal Revenue Service and the taxpayer.

2. ADVERTISING EXPENSES

The NATIONAL ASSOCIATION OF REALTORS® has associated itself with the Ad Hoc Group to Preserve the Deduction for Advertising. Testimony for that group was presented orally on September 8, 1993, and in written form, as well. We concur with the views presented therein concerning the periodic nature of advertising costs, and believe that these costs should continue to be fully deductible on a current basis.

We do wish to amplify the views of that coalition. We understand that the Subcommittee's proposal is intended to reflect the possibility that a successful advertising campaign will produce an intangible with a value that lasts more than one year. Most adults, for example, can recite or sing memorable advertising jingles from their youth or childhood. Such advertising campaigns, however, are significantly different from the advertising purchased by real estate brokerage firms.

National real estate franchises engage in advertising campaigns that are designed to enhance the value of that franchise. Those expenses, while related to the real estate brokerage franchise, are not the unique brokerage advertising expenses that should be distinguished in this case.

Each week, most real estate companies, whether large or small, local or regional, franchised or not, purchase advertising in the classified advertising section and/or real estate sections of local and regional newspapers, "shoppers" and similar time-sensitive consumer vehicles. The purpose of that advertising is to provide notices of homes that are available for sale any particular week, and to announce that certain homes will be available for "open house" inspections. The advertising identifies the broker so that sales agents can be located for prospective customers. In most cases the name of the broker is featured more prominently than the identification of any particular property. Nonetheless, the primary purpose of the advertisement is to provide notice to consumers.

The listings available in any particular week might be compared to inventory. Even during the recent downturn in some real estate markets, those inventories of listings rolled over or were replaced in much less than a year. The listings are not the same as inventory, however, because the brokerage has only an agency relationship with the true owner of the property. Thus, the notices are placed by a broker in its capacity as an agent for another. The advertisements are thus distinguishable from the advertisements of retailers who are also providing notices of inventories of goods available for sale. These notices, purchased as advertising, are of a transitory nature, and do not have as a primary purpose the enhancement of the broker/advertising purchaser's reputation.

We oppose any change to the treatment of advertising expenses. In the event the Subcommittee were to make changes to advertising expense treatment, we believe that advertised listings of property by real estate brokerages should be exempt from any change to current law because of the transitory nature of the announcement, because of the agency relationship between the broker and the owner of the property and because of the great complexity that the Subcommittee's proposal would introduce.

3. INDEPENDENT CONTRACTOR STATUS

The NATIONAL ASSOCIATION OF REALTORS® associates itself with the written remarks of Edward Delany & Associates in matters related to independent contractor status. We believe that more effective enforcement of current law will be the best means to assure uniform compliance with the law. We further believe that any revision of Section 530 should apply to all employers/service recipients, and not just to one industry.

4. ENVIRONMENTAL REMEDIATION COSTS

The NATIONAL ASSOCIATION OF REALTORS® has no official policy on the tax treatment of environmental remediation. We do believe, however, that these costs, which are often extensive and which have significant bearing on the value of many properties, should be recovered in an efficient and timely manner. We welcome the efforts of the Department of Treasury to study this matter. We urge the Subcommittee to approach this complex matter with due deliberation and care. We believe that there is not yet sufficient understanding of the potential scope of this issue. The NATIONAL ASSOCIATION OF REALTORS® will consider this issue at its next meeting in November 1993. We will be eager to share our deliberations with the Subcommittee thereafter.

5. LOBBYING EXPENSES

The NATIONAL ASSOCIATION OF REALTORS® opposes any further tax burden on lobbying expenses. In just the few weeks since the enactment of the Omnibus Budget Reconciliation Act of 1993 (OBRA), the lobbying expense rules as they affect trade associations have proven to be the most complex and most controversial provisions of the Act. A cottage industry is developing to assist companies and organizations in complying with that burdensome and controversial regime. The NATIONAL ASSOCIATION OF REALTORS® supported enactment of OBRA, but was vocal during deliberations on that legislation in pointing out the follies of the lobbying expense provisions. Just as the OBRA provisions are a harsh and unnecessary burden, so also is a regime that would impose an excise tax on lobbying expenditures.

The application of an excise tax on lobbying expenses would fall in an unduly harsh manner on trade associations as compared with businesses that lose a deduction for those expenditures. A Fortune 500 company or even a medium-size business could spend millions of dollars on lobbying without those expenditures ever being material to the financial health or bottom line of the business. When compared with such businesses, trade associations have small budgets and few revenue sources. Thus, for associations that engage in lobbying activities, lobbying expenses will always be very material to the bottom line. Hence, any direct tax on lobbying activities would have a serious adverse effect on the financial viability of the association. We believe that it is improper and unfair to impose a tax that will inevitably fall more harshly on an association of businesses than it would on a business.

When a business loses its deduction for lobbying activities, it pays 35 cents on the dollar. The theory of an excise tax is that, in economic terms, it would match the loss of deduction. An important distinction, however, is that in the case of an association, the lobbying activities are in the nature of a product line. An excise tax on any product line is substantially different from an excise tax on just one facet of an activity that comprises that product line. Just as a high rate direct tax on widgets would seriously impair a widget firm, so also a direct tax on lobbying expenditures of trade associations would seriously impair the information/lobbying product line of the association.

In the case of a trade association that represents small businesses, lobbying activities, including their vital education component, are valuable product lines. Individuals who own and operate small businesses have little individual "buying power" in the legislative information and education arena. A trade association provides that collective "buying power." Taxing the product of that association is harsh, indeed.

6. TRAVEL EXPENSES

The Subcommittee proposes eliminating the deduction for ordinary and necessary travel expenses incurred by individuals who own and maintain properties in a location different from their primary residence, unless those individuals are in the trade or business of property management. The NATIONAL ASSOCIATION OF REALTORS® opposes this proposal. It would have an unduly harsh effect in certain regions of the country where individuals own vacation properties. We believe that any provision that would fall unevenly on geographic areas is improper and ill-advised.

The Subcommittee may be concerned that taxpayers might be taking improper deductions for expenses that are of a personal nature. We believe that the extensive and complex regime of Code Section 280A provides standards for measuring personal use of vacation properties and determining whether a property is being utilized as a rental property. We believe that adequate enforcement of that Section should be an adequate safeguard against the improper deduction of personal expenses.

7. MILEAGE ALLOWANCES

Two provisions in the miscellaneous revenue-raising proposals would negatively impact real estate professionals. One proposal would freeze the standard milage rate used to determine deductible automobile expenses incurred for the business use of a vehicle at the 1993 level for future taxable years. Additionally, the Internal Revenue Service would round down automobile deduction calculations to the nearest whole cent. The other proposal would limit the business mileage deduction for trips beginning at the taxpayer's home to mileage in excess of 10 miles.

The vast majority of NATIONAL ASSOCIATION OF REALTORS® members are self-employed individuals. These two provisions would unfairly burden self-employed individuals such as our members.

The nature of the real estate sales business is automobile intensive. The NATIONAL ASSOCIATION OF REALTORS® data indicate 28% of a Realtor's® total business expenses is automobile related. In addition, The NATIONAL ASSOCIATION OF REALTORS® data show 92% of our members utilize their automobile for business purposes. The average REALTOR® member drives 16,920 miles per year for business purposes, the majority of which originates from the home. We anticipate the average number of miles driven per Realtor member to increase since fewer real estate agents are servicing a more or less constant number of home transactions.

As automobile costs continue to increase, the 1993 standard mileage rate will not reflect true costs of doing business and is burdensome for the real estate professionals who are highly dependent upon cars to conduct business. Excluding the first 10 miles of each trip originating at the taxpayer's home, is inequitable to self-employed individuals who generally start such trips from their home when compared to other taxpayers who incur business use expenses for automobiles.

NCSSSA

National Conference of
State Social Security Administrators

PO BOX 557
FRANKFORT, KY 40602

September 10, 1993

The Honorable Charles Rangel, Chairman
Select Revenue Measures Subcommittee
Committee on Ways and Means
United States House of Representatives
1102 Longworth House Office Building
Washington, D. C. 20515

Attention: Janice Mays
Chief Counsel and Staff Director

Dear Chairman Rangel:

The National Conference of State Social Security Administrators, on behalf of more than 70,000 state and local government employers, continues to seek administratively prudent and equitable federal employment tax rules, regulations and reporting requirements. The NCSSSA has worked with Congress, the Treasury, the Internal Revenue Service and the Social Security Administration for more than 40 years to improve voluntary compliance with federal requirements by state and local government employers.

With this in mind and on behalf of our members, the NCSSSA offers the following comments for inclusion in your September 8 and September 14 subcommittee hearings.

Proposals for September 8, 1993

* The NCSSSA supports the proposal designating certain university and agency accounts as related corporations in regards to Social Security tax rules for concurrent employment by two or more employers.

* The NCSSSA supports the proposal to freeze the standard mileage rate used to determine deductible automobile expenses incurred for business at the 1993 level for the 1994 tax year and to round down the amount computed by the IRS to the nearest whole cent.

The NCSSSA encourages the elimination of the annual review of mileage rates. We recommend using standard indexing to project and produce new rates. Further, we recommend that any new rates be announced to employers no later than December 1 of each year. By doing so, employers can start each new tax year by applying the new rate prospectively instead of retroactively.

Proposal for September 14, 1993

* The NCSSSA opposes the proposal to increase the rate of withholding on bonuses from 28 percent to 36 percent. The supplemental withholding rate is being raised from 20 percent to 28 percent, effective January 1, 1994. Employers can readily make this change as the 28 percent applies to all supplemental payments. Isolating one unique type of supplemental payment (bonuses) for a 36 percent rate, would cost employers millions of dollars because all automated payroll systems would have to be modified to accommodate this one exception.

Thank you for your time and consideration of these issues. If additional information is needed by any member of the subcommittee or staff, please call (502) 564-3952 at your convenience.

Sincerely,

Daryl Dunagan
President, NCSSSA 1993-94

Organization for
International Investment

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STATEMENT OF
ORGANIZATION FOR INTERNATIONAL INVESTMENT INC.
TO THE SUBCOMMITTEE ON SELECT REVENUE MEASURES
OF THE HOUSE COMMITTEE ON WAYS AND MEANS
SEPTEMBER 21, 1993

The Organization for International Investment (OFII) appreciates this opportunity to make known to the Subcommittee the views of OFII members on certain foreign tax provisions contained in the miscellaneous revenue proposals that were the subject of a hearing on September 21 and are further described in the Joint Committee on Taxation Pamphlet JCS-12-93, dated September 16, 1993.

OFII comprises more than fifty major companies representing a broad cross section of the manufacturing and service sectors. The parent companies of OFII members are headquartered in countries throughout the world, including the United States' major trading partners. OFII members include some of the largest foreign investors in America. OFII's primary aim is to support the principle of "national treatment" and defend longstanding U.S. policies that favor an open international investment system.

REPEAL PORTFOLIO INTEREST EXEMPTION.

OFII agrees with the testimony given by Assistant Secretary of the Treasury, Leslie B. Samuels, that repeal of this exemption would increase the borrowing costs of both the U.S. Government and U.S. corporations. Since OFII members are U.S. corporations, employing collectively more than 500,000 American workers, they have a vital interest in keeping the cost of funds as low as possible. It is not always possible to obtain needed funds for expansion from U.S. sources. Foreign lenders may, at times, be the only source for certain business loans. Repeal of the exemption would drastically reduce the ability of U.S. businesses, particularly in the manufacturing sector, to obtain funds at affordable interest rates. The net effect of the repeal would be to restrict business expansion rather than to raise significant amounts of revenue. The resultant increase in the U.S. interest rates would exert a very depressing effect on the struggling U.S. economy. By increasing borrowing costs and the subsequent interest deductions, this change could also have the anomalous effect of **lowering** U.S. corporate taxable income.

Excise Tax on Insurance Premiums Paid to Foreign Persons.

Increasing the rate of the current excise tax will adversely affect the entire U.S. insurance industry. This proposal will increase the cost of reinsurance for both foreign-owned and U.S.-owned companies. There is a close connection between foreign reinsurance and the U.S. insurance industry. In the event the rate of tax is increased, foreign governments may feel compelled to maintain or even erect barriers to U.S. insurers doing business in foreign nations. OFII believes that U.S. competitiveness in the global insurance industry will be promoted by keeping these types of taxes to a minimum.

Excise Tax on Foreign Related Party Purchases.

OFII members are representative of the companies that would be directly targeted by the proposed tax. OFII fails to see what the tax would accomplish other than indicating official displeasure with foreign direct investment in the United States. Assistant Secretary Samuels stated in his testimony that the Treasury does not perceive this additional tax penalty as likely to improve compliance. To the extent that there ever has been a unique compliance problem with regard to foreign-owned U.S. companies, it has been addressed many times over. Foreign-owned U.S. businesses are already burdened with a number of discriminatory tax rules that denigrate the principle of "national treatment." OFII agrees with the Treasury that there are enough powers and penalties to ensure compliance with Internal Revenue Code § 6038A and other tax disclosure provisions. The proposed excise tax is totally unnecessary for compliance purposes and would send a strong negative message to foreign investors.

Role of Foreign Direct Investment in the U.S.

OFII urges that official recognition be given to the very important and positive role that foreign direct investment plays in the U.S. economy. For example, according to recently released data from the U.S. Department of Commerce, foreign-owned U.S. corporations employ 4.7 million Americans, pay higher compensation to those workers than their U.S.-owned counterparts, and are net contributors of technology to the U.S. economy.

It is OFII's belief that foreign-owned U.S. companies have been improperly characterized as not paying their "fair share" of taxes. To refute this unsubstantiated characterization, OFII has commissioned the accounting firm of KPMG Peat Marwick to do studies based on the latest available IRS statistics of income and other public information. The latest release of this study shows that tax payments made by foreign-owned U.S. companies rose **sharply** in 1990. Such companies paid $7.4 billion in 1990 income taxes, up 21 percent from 1989 and four times more than the $1.8 billion paid in 1983. Over the five-year period studied (1986-1990), **income taxes paid by foreign-owned U.S. corporations rose at an annual average rate of 25 percent**, compared with a 5.8 percent increase for U.S.-owned companies. In 1990, foreign-owned U.S. corporations and U.S.-owned corporations paid comparable effective tax rates, whether the calculation is performed on the basis of net worth, total assets or total receipts.

A copy of this study is attached for the information of the Subcommittee. It is OFII's belief that this study and others, including a June 1992 study by General Accounting Office, demonstrate that there is little reason to be concerned that foreign-owned U.S. corporations act differently in the market place or with regard to tax compliance than their U.S.-owned competitors.

Tax laws should not make both tax compliance and business operations more difficult solely because of the nationality of a taxpayer's shareholders. By promoting the principle of "national treatment," OFII hopes to encourage enactment of tax rules that will apply equally to all similarly situated taxpayers. Foreign-owned U.S. businesses do not seek special tax treatment, rather they simply seek equal treatment. Foreign-owned U.S. companies supply both high-paying employment and capital to the American economy, but these valuable contributions are jeopardized when each session of Congress brings new rules that single out foreign direct investments for harsh and discriminatory treatment.

The Subcommittee's consideration of these views of OFII's members is appreciated.

Alexander Spitzer
Chairman
OFII Tax Committee

Senior Vice President, Taxes
Nestlé Holdings, Inc.

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BATUS INC.
BET INC.
BP AMERICA CORPORATION
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KPMG Peat Marwick
Policy Economics Group

PRELIMINARY REVIEW OF 1990 IRS STATISTICS ON TAXES PAID BY FOREIGN CONTROLLED CORPORATIONS

The Organization for International Investment (OFII) asked the Policy Economics Group of KPMG Peat Marwick to review recent IRS statistics on taxes paid by foreign controlled corporations (FCCs). These 1990 figures show FCCs continue to pay substantial amounts of income tax to the federal government. Some of the highlight of these statistics are:

FCC Taxes Are Increasing Rapidly. FCC corporation income taxes paid to the U.S. Government in 1990 totaled $7.4 billion -- a 21 percent increase over 1989 levels. This is a consistent trend with FCC taxes having increased at a 25 percent average annual rate since 1986. In contrast, taxes paid by U.S. controlled corporations'[1] increased at a 5.8 percent average annual rate over the same 5-year period.

FCC TAXES PAID TO FEDERAL GOVERNMENT
(Billions of dollars)

1986	1987	1988	1989	1990
$3.0	$4.6	$5.8	$6.2	$7.4

FCCs and U.S. Controlled Corporations Have Similar Tax Burdens When FCC taxes are compared with those paid by U.S. controlled corporations using standard financial measures there are only minor differences in relative tax burdens. FCC taxes as a share of assets are similar to those paid by U.S. controlled corporations -- 0.5 percent compared with 0.6 percent. Similarly, FCCs paid taxes equal to 2.0 percent of their net worth, while U.S. controlled corporation payments equaled 2.1 percent. FCC taxes are a slightly smaller share of their total receipts at 0.7 percent than are U.S. controlled corporation taxes at 1.0 percent.

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[1] U.S. controlled firms are all corporations filing tax returns with IRS, less FCCs and less S corporations. S corporations are excluded because they are pass-through entities and generally do not pay corporation income tax.

TAXES PAID IN 1990 AS A PERCENT OF STANDARD FINANCIAL MEASURES

	Percent of Assets	Percent of Net Worth	Percent of Receipts
U.S. controlled	0.6%	2.1%	1.0%
Foreign controlled	0.5%	2.0%	0.7%

Higher FCC Tax Burdens Occur Despite Lower Pretax Rates of Return. These similar tax burdens arise even while FCCs show markedly lower pretax rates of return than do U.S. controlled corporations. Pretax net income as a share of total assets was 0.2 percent for FCCs and 2.1 percent for U.S. controlled corporations. FCCs earned only 1.1 percent of net worth, compared with 8.0 percent for U.S. controlled corporations. Corresponding percentages based on total receipts are 0.4 percent for FCCs and 3.8 percent for U.S. controlled corporations.

PRETAX NET INCOME IN 1990 AS A PERCENT OF STANDARD FINANCIAL MEASURES

	Percent of Assets	Percent of Net Worth	Percent of Receipts
U.S. controlled	2.1%	8.0%	3.8%
Foreign controlled	0.2%	1.1%	0.4%

Large Losses Experienced by Some FCCs Pull Down Overall Average Rates of Return. FCCs have lower net pretax rates of return than do U.S. controlled corporations primarily because pretax returns earned by profitable FCCs are substantially offset by large losses experienced by less successful FCCs. In 1990, reported FCC pretax net income was $4.0 billion. This net amount results from 39 percent of FCCs earning $29.4 billion and 61 percent experiencing losses of $25.4 billion. In contrast, U.S. controlled firms reported total pretax net income of $334 billion, with 53 percent of these U.S. firms reporting $491 billion of net income offsetting the 47 percent with $156 billion in losses. That is, the losses of U.S. controlled firms with losses were equal to about 32 percent of the earnings of U.S. firms with positive earnings. In contrast, the losses of FCCs with losses were much higher equalling 87 percent of the earnings of profitable FCCs.

COMPARISON OF 1990 EARNINGS AND LOSSES

(Billions of dollars)

	Income of Firms with Earnings	Losses of Firms with Losses	Total Pretax Net Income	Losses as a Percent of Earnings
U.S. controlled	$490.9	-$156.5	$334.4	31.9%
Foreign controlled	$29.4	-$25.4	$4.0	86.5%

Several Complex Reasons Help Explain FCC Lower Profitability While some of the issues raised by these statistics are complex, there are several possible explanations for the large losses experienced by many FCCs and the disparities in pretax rates of return.

> Start-up costs. FCC investments have grown very rapidly with an average annual increase in assets of 18.4 percent from 1986 to 1990, while the assets of U.S. controlled corporations grew annually by only 4.8 percent over the same period. High rates of growth, as a result of establishing new enterprises, through acquiring existing firms, or through internal investment, are often associated with reduced profitability in the early years of the investment. The very rapid growth of foreign investment during this period -- almost 4 times as fast as that of U.S. controlled firms -- has likely contributed reduced FCC profitability.
>
> High interest expense. Rapidly growing firms often grow through a greater use of debt. FCC interest costs are a significantly higher share of their earnings before interest is taken into account than are the interest costs of U.S. controlled firms. FCC net income after interest is only 4.9 percent of net income before subtracting interest expense, while for U.S. controlled firms net income after interest was 32 percent of net income before interest expense. The significance of this difference can be illustrated by calculating the effect on FCC net income if FCCs were to have had the same interest expense relationships as U.S. controlled firms. FCC net income would have been $23.3 billion rather than $4.0 billion. Of course, these same adjustments would also cause FCC tax burdens to be much higher than those of U.S. controlled firms.
>
> Exchange rate differentials. When the value of the dollar falls, the cost of imported goods and services rises. The Federal Reserve Board reports that the value of dollar fell in 1990 by 9.6 percent on a trade-weighted basis. As result, many U.S. controlled firms experienced a relative cost advantage over those FCCs that purchased a larger fraction of their goods and services overseas. In many cases, competitive forces did not allow FCCs to increase their prices to

compensate for this higher cost of doing business and, as a result, they experienced losses.

Historic cost accounting. Less rapidly growing firms may show artificially higher effective tax rates and pretax rates of return than more rapidly growing firms. This occurs when comparisons are made using balance sheet concepts, such as assets and net worth, that are generally recorded on an historic cost basis rather than at their current market value. Historic cost accounting tends to understate the market value of older assets. As a result, firms with assets reported at less than their market value will show misleadingly high effective tax rates and pretax rates of return. With investments by U.S. controlled firms having grown much more slowly than investments by FCCs, a larger share of U.S. controlled firm assets is likely to be old and potentially understated. Thus, pretax rates of return and effective tax rates of U.S. controlled firms are likely to be overstated relative to those of FCCs.

Intercompany transfer pricing practices. Critics have asserted that FCCs engage in transfer pricing manipulations to reduce their federal income taxes. The aggregation inherent in IRS statistical data make comparisons between FCCs and U.S. controlled corporations not very meaningful. Indeed, IRS does not use these data in transfer-pricing litigation because they are not sufficiently detailed to demonstrate that firms are comparable. The only way to determine whether transfer-pricing issues exist is on a case-by-case basis with a careful examination all the relevant facts.

IRS recently released some case-specific statistics on the results of their International Enforcement Division for fiscal year 1992.[2] These data include a breakdown of FCC and non-FCC significant cases, which are those with adjustments of $20 million or more and account for 90 percent of proposed adjustments. While certain assumptions are required, data provided in the report may be used to estimate total additional taxes proposed by the Service. The additional tax in Section 482 FCC cases was $383 million (computed at a 34-percent rate), while the additional tax in Section 482 non-FCC cases was $2,697 million.[3] Thus for these significant cases, FCCs represent 12.4 percent of proposed additional Section 482 taxes and U.S. controlled corporations represent 87.6 percent of proposed additional Section 482 taxes.

Letter to Percy Woodward of Ernst & Young from Paul Austin, Disclosure Officer, Internal Revenue Service

The report shows 18,760 hours were spent on FCC Section 482 cases with a tax yield of $20,400 per hour. Non-FCC Section 482 cases absorbed 104,538 hours with a revenue yield of $25,800 per hour. Because IRS did not release the total proposed adjustment for fiscal year 1992, we have calculated the adjustment by multiplying the hours worked by the tax yield per hour.

STATEMENT OF SENATOR HARRY REID

SEPTEMBER 21, 1993

BEFORE THE
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE COMMITTEE ON WAYS AND MEANS

Mr. Chairman and members of the Subcommittee, it has come to my attention that there are several tax provisions to be discussed here today that if adopted would affect the State of Nevada. I would like to take this opportunity to bring your attention to the very negative consequences of those provisions to not only one industry in my State, but to the statewide economy.

The first proposal involves limiting to 80 percent otherwise deductible gaming losses. The deductibility of gaming losses is already limited. Such losses are not permitted as offsets against any other form of income. The proposal before the Committee would have the effect of applying income tax rates, which are designed to be levied against net income, to a fixed percentage of gross gaming winnings. Gaming losses are an essential cost of generating income from gambling activities. Such costs are the most legitimate form of offset against gross income.

The provision to limit the deduction on gaming losses will go far beyond the Hotel/Casino industry in Nevada, it will also have a considerable impact on the nation's parimutuel businesses. The racing industry has been especially hard hit by the recent recession and this proposal would place an additional burden on this industry when they can least afford it.

The second proposal increases the excise tax on wagers from .25 percent to 1 percent. The excise tax on wagers was enacted a part of the Revenue Act of 1951. In imposing excise taxes on wagers both the Ways and Means Committee and the Finance Committee clearly stated that their main aim was to collect taxes from gambling activities that were "comparatively free [of taxation] from either State or Federal Governments." In other words, these excise taxes were not aimed at gaming operations that were regulated and taxed by state governments, but at activities which were operating outside state laws. The proposal now before the Select Revenue Measures Subcommittee contradicts this principle by increasing excise taxes on legal wagering activities already regulated and taxed by state government.

The impact of this proposal, intended or not, falls almost exclusively on gaming companies in Nevada. The impact is devastating. Sports books in Las Vegas average between 1 percent and 2.5 percent gross margins on wagers, with after-tax profit margins on wagers averaging about .5 percent to .75 percent. In reviewing the wagering activities of several major casinos in Las Vegas for the last five years, we find that in almost every instance, the proposed wagering excise tax increase results in after-tax losses by the sports books.

The third proposal before the Committee is to increase tax withholding on certain gaming winnings from 28 to 36 percent. The rationale for tax withholding has always been based on the principal that taxes should be withheld at the time income is earned, up to the limit of likely tax liability. This was to ensure that the federal government actually received the taxes due it, and that such taxes were received in a timely fashion. The proposal before the Committee does not meet this test. First, even existing withholding provisions do not ensure that taxes withheld from gaming winnings approximate the tax liability that the taxpayer may actually incur. Taxes are withheld against gross gaming winnings, and by the end of the year the taxpayer may end up with little or no tax due on his or her gaming activities because of subsequent losses. Further, even should the taxpayer have net gaming winnings, it is very unlikely that the taxpayer would incur a tax obligation of anything near 36 percent of his or her winnings. According to Tourist Convention records, the typical person visiting a Nevada casino is between the ages of 35 and 50, married, and has an annual income of between $25,000 and $60,000. Less than 5 percent of those gambling in our casinos would fall in the 36 percent tax bracket.

The Administration and Congress recently reaffirmed that withholding should reflect as closely as possible the taxpayer's actual tax obligation. In the Omnibus Budget Reconciliation Act (OBRA) of 1993, withholding on bonuses was set at 28 percent, the current rate at which taxes on gaming winnings are withheld.

Nevada's economy is heavily reliant on tourism, and as a result of tax laws enacted in OBRA 1993, the tourism industry in Nevada will be negatively affected. Not only will the new tax laws increase the corporate income tax for the Hotel/Casino industry, the reduction to the business meal and entertainment deduction will also have a negative affect on the earnings of Hotels/Casinos. This will, in turn, reduce available funds to state and local governments that depend on revenues from gaming operations. The gaming industry and the people of Nevada accepted these changes because of the dire need to gain control of our federal deficit for the good of all Americans, and because the burden will be shared by all sectors of our economy. However, parochial raids on our primary industry cannot by justified.

I strongly urge this Subcommittee to address these issues with the concerns of Nevada in mind.

STATEMENT

of

TAX EXECUTIVES INSTITUTE, INC.

on

MISCELLANEOUS REVENUE-RAISING MEASURES
(Press Releases 9, 10, 11, and 12)

at a hearing before

SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

September 22, 1993

On behalf of Tax Executives Institute, I am pleased to provide the following comments on several miscellaneous revenue-raising measures that were or will be the subject of hearings by the Subcommittee on Select Revenue Measures on September 8, 21, and 23, 1993. The Institute requests that the comments be associated with the hearing record.

Background

Tax Executives Institute is the principal organization of corporate tax professionals in North America. Our approximately 4,900 members represent more than 2,400 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community, and is dedicated to the development and effective implementation of sound tax policy, to promoting the uniform and equitable enforcement of the tax laws, and to reducing the cost and burden of administration and compliance to the benefit of taxpayers and government alike.

The Institute is firmly committed to maintaining a tax system that works — one that is consistent with sound tax policy, one that taxpayers can comply with, and one in which the IRS can effectively perform its audit function. It is with that commitment in mind that we offer the following comments and observations on the revenue-raising measures that were summarized in the Subcommittee's Press Releases No. 9-12.

Overview

> *Don't tax you, don't tax me —*
> *Tax that fella behind the tree.*

This aphorism, which has been attributed to former Senator Russell Long, aptly describes the plethora of proposals under consideration by the Select Revenue Measures Subcommittee: an exercise in searching out "that fella behind the tree." To paraphrase Pogo, however, we have found that fella and he is us. Tax Executives Institute concedes that the proposals before the Subcommittee would raise revenue, but respectfully submits that, almost without exception, they do not merit serious consideration. Taken as a whole, they are gargantuan in scope, bereft of detail, generally devoid of any compelling tax-policy basis, blind to the administrative costs they would impose, and driven by nothing so much as the money they would raise and the oxen they would gore.[1]

At any time, the menagerie of proposals before the Subcommittee would be daunting, but at the present uncertain time their advent is especially disconcerting. In the midst of a still-stalled economic recovery, weeks after the enactment of the Omnibus Budget Reconciliation Act of 1993, and days before the President unveils his comprehensive health care proposals, the hodge-podge of proposals stands as an edifice to what is wrong with tax policy in the 1990s. The proposals reflect precious little appreciation for the interplay of tax policy with economic policy and international competitiveness and scant, if any, recognition of the administrative and compliance costs associated with endless tinkering with tax law provisions.

In a word, the proposals before the Subcommittee epitomize "hyperlexis" — excessive complexity in the law — which has been mirthfully defined as "a pathological condition caused by an overactive law-making gland."[2] The proposals, however, are not themselves mirthful: they represent the antithesis of simplification and have a destabilizing effect, not only on the tax system but on international markets and the economy as a whole.

Consider, for example, the proposal to reinstate the withholding tax on interest received by foreigners on certain portfolio investments. Such a proposal ignores that U.S. businesses operate in a global market. Its effect would not be to "punish" foreign lenders but to increase the net cost of borrowing — costs that would be borne by U.S. borrowers (including the government).[3] As the Subcommittee is well aware, the proposal significantly disrupted the international financial markets and recently necessitated a formal disavowal from the Treasury Department. TEI is pleased that the Administration moved quickly to quell the instability in the international markets and that it reiterated its opposition to the proposal during its September 21 testimony before the Subcommittee.[4]

Several other proposals deserve note because they reflect either disregard for proposals Congress has already enacted, misunderstanding of the burdens they would impose on taxpayers, or the type of gimmickry and sleight-of-hand that undermines public confidence in the tax system:

- The proposal to impose a 30-percent excise tax on expenditures of tax-exempt organizations for lobbying (including amounts paid as salaries and an allocable portion of support costs) comes on the heels of OBRA's opprobrious disallowance of deductions for lobbying expenditures (which has a raft of special rules governing expenditures by tax-exempt membership associations). TEI is pleased that the Administration opposed the proposal during its September 21 appearance before the Subcommittee.

- The proposal to increase estimated tax payments under the safe harbor method to 115 percent of last year's liability for individuals with adjusted gross income over

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[1] The inadequacy of information available to the public about the proposals was underscored by the issuance on September 16 — *after* the first day of hearings and mere days before the close of the hearing record — of a description of the proposals before the Subcommittee by the staff of the Joint Committee on Taxation. STAFF OF JOINT COMMITTEE ON TAXATION, *DESCRIPTION OF MISCELLANEOUS REVENUE PROPOSALS (JCS-12-93)* (Sept. 16, 1993). The Joint Committee's description contains useful background information on the proposals that could materially contribute to the overall debate on the proposals. That interested parties were effectively denied access to that information in preparing their testimony is at once frustrating and infuriating, and it certainly does not burnish the hearing process. Even with the Joint Committee's description, moreover, interested parties are left guessing about the full scope of many of the proposals.

[2] Bayless Manning, *Hyperlexis: Our National Disease*, 71 NORTHWESTERN UNIVERSITY LAW REVIEW 767 (1977), *quoted in* Gordon Henderson, *Controlling Hyperlexis — The Most Important "Law And . . .,"* 43 TAX LAWYER 177, 183 (1989).

[3] Because foreign lenders possess the leverage in most borrowing transactions, the withholding tax will in effect become an additional expense; U.S. borrowers will be required to gross-up their interest payments to cover the tax, thereby increasing their cost and causing more money to leave the United States.

[4] *See* Statement of Leslie B. Samuels, Assistant Secretary of the Treasury for Tax Policy, before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means (September 21, 1993).

$150,000 effectively requires taxpayers to overpay their income taxes in order to avoid any penalty attributable to their inability to estimate their tax liability with certainty. What's more, the proposal comes even before OBRA's change to the estimated tax rules (increasing the applicable percentage rate to 110) has gone into effect and, hence, before Congress could possibly determine whether a further increase is necessary. The Clinton Administration is to be commended for opposing the proposal.

- The proposal to require written substantiation of any meal or entertainment expense claimed as a business deduction or, alternatively, to require written substantiation of any meal or entertainment expense in excess of $10 seems untethered to reality, in that it would impose a requirement to secure receipts from, among other places, fast-food restaurants and vending machines. Moreover, the proposal disregards the OBRA conferees' rejection of a Senate proposal to reduce the substantiation threshold to $20.[5] We are pleased that the Administration shares our opposition to this proposal.

The *deja vu* quality of many of the proposals — the seeming disregard for the fact that Congress considered and either enacted or rejected similar proposals as recently as two months ago — is disturbing, for it feeds the instability that already marks the tax law. In the aftermath of the Tax Reform Act of 1986, there was much talk of the need for a moratorium on new tax legislation in order to give both taxpayers and the Internal Revenue Service a chance to implement and become accustomed to the massive changes the 1986 Act wrought. Although prospects for a full-scale moratorium were no doubt always illusory, there would clearly be ongoing benefits in adopting a "cooling off period" rule with respect to particular proposals. We applaud the Administration for making this same plea for stability during the Subcommittee's September 21 hearing, and urge the Subcommittee to reject the oft-resurrected proposals with dispatch.

Even more alarming than the "Friday the Thirteenth," Jasonesque character of many of the proposals, however, is their aggregate distension of the Sixteenth Amendment's imposition of a *net* income tax. People are supposed to be taxed on *income* not on gross receipts, but certain of the proposals do not concede that. Hence, several of the proposals — those in respect of environmental clean-up expenditures and damages, advertising expenses, and interest on tax underpayments — violate the precept that deductions are generally allowed for the expenses of producing that income.

The proposals also ignore the fact that the United States does not function in a vacuum: it is part of an increasingly interdependent global community. One of the more overreaching proposals would myopically penalize multinational corporations for operating in that global economy by replacing the foreign tax credit with a deduction. Such a proposal would result in double taxation, violate numerous bilateral treaties, and place U.S. companies at a severe competitive disadvantage. Other proposals would undermine the competitive position of the U.S. economy for capital investment and job creation by increasing the cost of doing business in the United States. Whenever a legitimate business expense deduction is denied or an additional compliance cost is imposed, the competitive position of the country as a whole is clearly diminished. That the Clinton Administration generally shares this view is laudable.

As the foregoing discussion makes clear, Tax Executives Institute has significant misgivings about many of the proposals under consideration. Although the Institute endorses the process the Subcommittee has employed to afford taxpayers an opportunity to express their views (other than the untimely issuance of the Joint Committee's description), we view most of the proposals should be promptly and soundly rejected. In the ensuing sections of this statement, we set forth our specific comments on several proposals, and wish to confirm our willingness to meet with the Subcommittee and its staff to elaborate on our concerns.

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[5] Three other proposals before the Subcommittee would increase the withholding rates with respect to bonuses, gambling winnings, and backup withholding. There has been no showing, however, that there have been underpayments of tax with respect to these payments. Hence, the proposals could at best be described as revenue shifters, not revenue raisers, and at worst as smoke and mirrors unbefitting the tax code. We are pleased that the Administration has announced its opposition to the bonuses and backup withholding proposals and its decision not to support the proposal concerning gambling winnings.

Deductibility of Environmental Remediation Expenditures

The federal income tax treatment of environmental remediation expenditures affects nearly every taxpayer engaged in manufacturing, natural-resource extraction, transportation, and related industries. Taxpayers face a plethora of costs to comply with myriad environmental laws imposed by federal, state, and local authorities. Although there is no statutory provision specifically governing the federal income tax treatment of environmental costs, taxpayers have generally considered remediation expenditures deductible when incurred on the grounds that such expenditures repair and restore environmentally damaged property to its condition immediately before the condition necessitating the expenditures. As repairs, the expenditures are deductible as ordinary and necessary business expenses under section 162 of the Internal Revenue Code.

Two proposals under consideration by the Subcommittee would affect this long-accepted treatment: the first would disallow the cost of compensatory damages under certain environmental laws, and the second would reverse the longstanding deduction for environmental remediation costs by requiring either capitalization of certain costs or capitalization and amortization of certain expenses over uniform periods. In considering the merits of the proposals, Congress should bear in mind the underlying social policy prompting the enactment of federal, state, and local environmental protection statutes: to promote and protect a clean, healthful environment based on known environmental risks and cost-effective technological responses to prevent the discharge of or to remove environmentally damaging substances. TEI sincerely believes that attaining this laudable goal would be seriously impeded by adoption of either proposal. On this basis alone, the proposals should be rejected. In addition, the proposals are flawed as a matter of tax policy.

A. Compensatory Damages for Environmental Lawsuits

If Congress enacted the proposal to disallow deductions for the cost of compensatory damages under certain environmental laws, it would create an artificial distinction in the tax law for certain types of costs associated with the manufacture and distribution of products. More specifically, the costs of compensatory damages arising from other forms of civil liability — for example, product liability claims — would remain entirely deductible, whereas the cost of resolving environmental claims would be nondeductible. No justifiable reason exists for such a distinction. The Administration made this point forcefully during its September 21 testimony.

The proposal should be rejected for another, not insubstantial reason: the cost of resolving environmental lawsuits would substantially increase — by 35 percent (the value of the otherwise allowable deduction). Enactment of the proposal would likely increase the propensity of affected businesses to contest either the fact of liability or the amount of compensatory damages to the absolute limits of the administrative and judicial system. The proposal would thereby perversely undermine what should be a principal societal goal: a rapid response and clean-up of environmental damage.

B. Capitalization of Environmental Remediation Expenditures

TEI also opposes the proposal to upend the current deduction for environmental remediation costs and to require either (i) capitalization of certain costs or (ii) capitalization of certain costs and amortization of such costs over uniform periods. To our mind's eye, the proposal misapprehends core principles of the tax system as well as the nature and purpose of remediation expenditures.

Although the alternative of permitting amortization of capitalized costs over a specified period is less obnoxious than the proposal simply to require capitalization, TEI believes either option would detrimentally affect the goal of expeditiously and thoroughly remediating environmental damage. Two recent technical advice memoranda issued by the Internal Revenue Service improperly conclude that certain clean-up expenditures should be capitalized, and TEI has prepared a detailed submission demonstrating why the legal analysis employed by the IRS in the rulings was flawed and produced incorrect results. (A copy of our analysis will be provided to the Subcommittee on request.) Although efforts are underway to persuade the IRS administratively to correct its interpretation of the law, a legislative remedy may prove necessary.[6] To the extent legislation is needed to clarify the proper treatment of environmental remediation expenditures, TEI strongly believes that Congress should confirm that section 263 — which requires the capitalization of certain expenses — does *not* apply to most environmental clean-ups.

In conclusion, TEI urges Congress to reject the proposal to disallow deductions for compensatory damages related to environmental lawsuits. TEI also recommends the rejection of the proposal to require capitalization (with or without amortization) of remediation expenditures. Instead, TEI submits that the Subcommittee should confirm that environmental clean-up expenditures are generally deductible when incurred.

Capitalization of Advertising Expenses

A proposal under consideration by the Subcommittee would require capitalization and amortization of advertising expenses over a period of years. TEI recommends that the Subcommittee reject the proposal because it lacks a sound basis in either tax policy or economic effect.

Expenses incurred to promote products, services, or institutional goodwill have been deductible as ordinary and necessary business expenses since the inception of the income tax. The longstanding treatment has been sanctioned by the courts and has been accepted by the IRS, which recently affirmed the generally deductible nature of advertising under section 162 of the Code in Rev. Rul. 92-80, 1992-2 C.B. 57. In that ruling, the IRS averred that there may be *some* future effect on business activities, as in the case of institutional or goodwill advertising, but that the future benefit is not significant enough to warrant capitalization.

The theory underlying the proposal before the Subcommittee — to the extent there is one — is that advertising expenditures produce a significant benefit beyond the year in which the expenditures are made. There is little or no evidence, however, to support the notion that advertising produces significant future benefits that are separate or distinct from the immediate present benefit that arises from product or service advertising. Nor is there any evidence suggesting that the use of a uniform amortization period in respect of all advertising expenses would be anything but arbitrary and inequitable. (The Administration echoed this assessment during its testimony at the Subcommittee's September 21 hearing.) Thus, the proposal would lead to a substantial mismatching of income and expenses.

Tax policy aside, the proposal flunks the test of sound tax administration. It would require taxpayers and the IRS alike to expend substantial resources in determining what is and what is not advertising. The proposal would doubtless lead to numerous audit disputes, and the resulting uncertainty and instability could not help but impair the smooth operation of the tax system and the competitive position of business taxpayers. Like the uniform capitalization rules (which were enacted in 1986), the advertising capitalization proposal might produce a one-time revenue pick-up for the fisc but would impose recurring and onerous recordkeeping and compliance burdens on taxpayers.

Finally, TEI believes that requiring the capitalization and amortization of expenses for some evanescent, undefinable future benefit that is wholly inseparable from the present benefit of advertising would impair the free flow of product and price information to consumers in this country. In the absence of any sound economic evidence that the present commercial benefit of advertising expense may be segregated from a tenuous or incidental future benefit, the proposal should be rejected as arbitrary, unsound, and insupportable.

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[6] During the Subcommittee's September 21 hearing, the Administration announced that the capitalization and amortization proposal was "under study."

Stock Options as Qualifying Expenses for Purposes of the Research Tax Credit

A proposal before the Subcommittee would disallow the compensation expense portion of stock options as a qualifying expense for purposes of the research tax credit under section 41 of the Code. Thus, the proposal would decouple the treatment of stock options for income tax withholding and employment tax purposes (in respect of which they are treated as "wages") from their treatment for purposes of the research tax credit. TEI opposes the proposal, and is disappointed that the Administration has stated that it would not oppose the proposal.

Stock options represent a means of compensating employees through performance-based incentives — particularly in technology-based industries where research is critical to the development of products and processes. In addition, stock options generally represent a long-term approach to compensating employees, rewarding those who remain with a company over a long period of time. This is especially important in attracting and retaining a stable group of research employees because research efforts often require a multi-year period. Indeed, in many entrepreneurial companies, stock options are a critical component of total compensation used to attract and retain scientific and engineering talent on a long-term basis.[7]

The proposal to disallow the compensation expense element of stock options as a qualifying expense for purposes of the research tax credit would undermine the incentive effect of the credit by compelling many companies to consume their cash resources to compensate their employees (and thus preserving the amount of the credit to the company) or risk losing staff to better-financed competition. The proposal would thus diminish the chances for success among companies whose principal assets lie in the creative abilities of their research staffs to develop inchoate ideas into commercially successful products.

The proposed disallowance would perversely inhibit the very risk-taking behavior the research tax credit is designed to foster. Accordingly, TEI urges the Subcommittee to reject the proposal to disallow the compensation expense portion of stock options as a qualifying expense for purposes of the research credit.

On-Line Telephone Access to Taxpayer Identification Numbers

A proposal under consideration by the Subcommittee would require the IRS to establish an on-line electronic transmission facility to enable payers to obtain access to taxpayer identification numbers (TINs) on a dial-up basis. TEI supports efforts by Congress to encourage the IRS to exploit emerging technologies to enhance compliance — in the service industry and elsewhere — to minimize payer and payee burden relating to information reporting. We believe, however, that many questions remain before information reporting obligations should be significantly expanded. Consequently, although we recommend that the Subcommittee pursue a telephone verification system, we believe it should move with caution in this area.

During the debate over the Clinton Administration's "service industry non-compliance" (SINC) proposal — a provision ultimately omitted from OBRA — TEI argued that no information reporting regime for services should be imposed unless the IRS were capable of supplying payers with information on a payee's TIN and status on a timely basis. We were pleased that the OBRA conferees agreed that SINC should not be adopted.[8] Even apart from SINC or other efforts to expand information reporting requirements, a TIN-verification program would be helpful in minimizing payer burden. If Congress were to expand the scope of the tax law's current reporting requirements, a verification system would be absolutely essential.

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[7] Even the ill-advised OBRA legislation restricting the deductibility of compensation expense in excess of $1 million provided exceptions for performance-based incentives, including stock options, in recognition of the importance of stock options as a means of compensating employees.

[8] Contrary to the Administration's statement during the Subcommittee's September 21 hearing, TEI believes that Congress's rejection of SINC was not due to opponents' "misunderstanding" the proposal but rather to legitimate and demonstrable concerns about the burdens that SINC would impose on both payers and payees.

Thus, TEI renews its recommendation that the Congress establish an effective on-line facility permitting payers to verify payee TIN data as an absolute prerequisite to an effective, targeted information reporting regime. With an on-line telephone facility, the IRS would be able to segment taxpayers by their level of compliance with the tax laws. Moreover, through TIN verification, payers would be able to determine whether information returns should be filed or backup withholding instituted with respect to their payees.

While a host of technical and policy obstacles must be overcome before expanded information reporting requirements can be effectively and efficiently imposed, the establishment of an on-line telephone verification facility is clearly a necessary step. TEI urges the Subcommittee to move forward in this area. Even an operational verification system, however, is no substitute for well-defined enforcement programs that are targeted to verifiable areas of noncompliance.

Repeal of Section 530 of the Revenue Act of 1978

A proposal under consideration by the Subcommittee would repeal section 530 of the Revenue Act of 1978 (relating to the classifications of workers as independent contractors) for construction industry workers. TEI opposes the proposal because it would remove the certainty of section 530's safe harbors without providing any basis for resolving employment tax controversies. We are pleased that the Administration similarly opposes the proposal.

Section 530 was enacted in 1978 in response to congressional concern that the IRS had acted too aggressively in classifying certain workers as employees rather than independent contractors under the so-called common law test. Although originally enacted as a temporary measure to afford Congress an opportunity to tailor a permanent, statutory solution, the provision was subsequently made permanent by Congress. In the 15 years since the enactment of section 530, numerous questions have arisen concerning the scope and application of the provision.

TEI supports the statutory clarification of the tax law's worker classification rules and sees benefit in making section 530 part of the Internal Revenue Code. We do not, however, support efforts to strip taxpayers generally — or discrete classes of taxpayers — of the protection of section 530 without substituting a comprehensive set of rules. In the absence of such comprehensive action, the uncertainty and potential for IRS abuse that gave rise to the enactment of section 530 could well reemerge.

Accordingly, we oppose the proposal to repeal section 530 as it applies to workers in the construction industry.

Deduction for Interest Paid on Corporate Tax Underpayments

A proposal under consideration by the Subcommittee would deny corporations a deduction for all (or part) of interest paid to the IRS on tax underpayments. TEI opposes the proposed disallowance for the both policy and administrative reasons, and commends the Administration for announcing its opposition to this odious proposal.

First, the proposal is unjustifiably punitive. Undergirding the proposal is an inference that the underpayment of tax is an act of significant culpability that deserves punishment (by means of disallowing a deduction for interest paid on that underpayment). Thus, the proposal would apparently apply in respect of all interest paid on all tax underpayments, without regard to either the good faith of the taxpayer or the fact that high interest charges in respect of corporate tax disputes are frequently attributable to *government-caused* audit delays.

Secondly, the proposal is at odds with longstanding and legitimate tax law principles. Under current law, taxpayers are properly accorded a deduction for ordinary and necessary business expenses. Interest paid on business-related indebtedness is one such expense. Thus, if a company borrows to purchase business-related equipment, the interest on the loan is deductible as a cost of doing business. Interest paid to the government on tax underpayments represents the identical type of expense. No policy reason exists to distinguish interest paid for federal tax purposes from other interest payments.

Thirdly, the proposal could disrupt the orderly administration of federal, state, and foreign tax audit systems. Currently, the IRS and other taxing authorities are unable to conduct timely audits of many corporations and regularly seek extensions of the statutes of limitations in order to complete their examinations. If the proposal were enacted and corporations were denied a deduction for interest paid on overpayments in respect of any extended period, taxpayers would likely be less willing to agree to such extensions.

For the foregoing reasons, Congress in 1990 refused to enact a comparable provision,[9] though it did enact an enhanced interest rate in respect of so-called large corporate tax underpayments. Without regard to whether the 1990 provision was justified — and TEI fervently believes it was *not* — there is no basis for denying corporate taxpayers a deduction for a legitimate business expense — interest paid on their tax liabilities. Thus, the proposal to disallow a deduction in respect of interest paid on corporate tax underpayments should be rejected.

Increased Interest Rate on Corporate Tax Underpayments

A proposal under consideration by the Subcommittee would increase the rate of interest payable on corporate tax underpayments. Because the proposal would belie the purpose of the Internal Revenue Code's interest provisions — to compensate the government for the time-value-of-money — and would be punitive, TEI joins the Administration in recommending its rejection.

Under section 6621(a) of the Code, a taxpayer is charged interest on underpayments of tax at a rate equal to the federal short-term rate plus three percentage points. In contrast, a taxpayer receives interest on an underpayment of tax at a rate equal to the federal short-term rate plus two percentage points. In 1990, Congress concocted section 6621(c) which increases by two percentage points the interest rate payable by corporate taxpayers on tax underpayments exceeding $100,000. Thus, under this "hot interest" provision, corporate taxpayers now pay a three-percentage-point higher interest rate on large corporate underpayments than they receive on corporate overpayments.

TEI submits that the interest rate differential (with or without regard to its hot interest component) is not only unnecessary, but undermines what should be a precept of the tax system: evenhandedness. The interest rate differential was purportedly enacted because of congressional concern that the interest rate prescribed in the tax law may have caused taxpayers "either to delay paying taxes as long as possible to take advantage of an excessively low rate or to overpay to take advantage of an excessively high rate."[10] Even if this rationale were valid when the interest rate was determined every two years, changes *more than a decade ago* that required more frequent adjustment of the rate eliminated the potential for any significant differential between the market rate and the tax interest rate. The only reason for the differential — which would be exacerbated by the proposal before the Subcommittee — is to exact a greater-than-market rate of interest from taxpayers as a punitive measure.

Taxpayers need to know that their government is dealing fairly with them. Taxpayers have no freedom to negotiate interest rates and terms with the government, as they might with a commercial establishment — the government offers taxpayers a deal they cannot refuse. That deal should be fair. Rather than increasing the interest rate differential, the Subcommittee should eliminate it altogether. At a minimum, the proposal to expand the differential should be rejected.

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[9] H.R. Rep. No. 101-964, 101st Cong., 2d Sess. 1100-01 (1990).

[10] STAFF OF THE JOINT COMMITTEE ON TAXATION, *GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986*, at 1279 (1987).

Modification of Inventory Source Rule

A proposal under consideration by the Subcommittee would modify the method by which the sale of inventory property is segregated between U.S. and foreign sources under section 863(b) of the Code.[11] Specifically, the proposal would impose a limit on the amount of section 863(b) income attributable to production activities where the inventory property is sold by the taxpayer to a related person. The amount attributable to production activities could not be less than the portion of the combined taxable income of the taxpayer and the related person attributable to the inventory property that would have been apportioned to production activities under section 863(b) had both parties been treated as one U.S. taxpayer.

TEI joins the Administration in not supporting the proposed modification of the inventory-source rule. The proposal should be rejected because it would adversely affect U.S.-based companies that manufacture in the United States and use a foreign subsidiary to market their exports,[12] whereas companies dealing with an unrelated party would not be subject to the same restrictions. When Congress considered and rejected proposed changes to the title passage rule in 1986, the Senate Finance Committee concluded that "with the substantial trade deficits of the United States, it [did] not want to impose any obstacles on U.S. business that may exacerbate the problems of U.S. competitiveness abroad."[13]

The policy reservations expressed by Congress in 1986 remain valid today. Moreover, the proposal raises significant compliance issues since there is no indication how a taxpayer determines the portion of a foreign affiliate's income that is attributable to the exported product. Accordingly, TEI recommends that the proposal be rejected.

Change of Foreign Tax Credit to a Deduction

A proposal under consideration by the Subcommittee would transmute the foreign tax credit into a deduction.[14] TEI strenuously opposes the proposal as misapprehending the overarching purpose of the foreign tax credit and as threatening the competitive position of U.S. business vis-à-vis their foreign competitors. We agree with the Administration that the proposal should be rejected as misguided and counterproductive.

When the income tax was enacted in 1913, taxpayers were granted a deduction for taxes paid to foreign governments. The deduction for foreign taxes was changed five years later to a credit and the reason for the change is as valid today as it was 75 years ago: to avoid the double taxation of income.[15] Although legislation since that time has limited taxpayers' ability to utilize the credit, it remains today the multinational corporation's most significant defense against taxation of the same income by both the country of origin and the United States.

Elimination of the foreign tax credit would not only make manifest the specter of double taxation, but it would violate the numerous bilateral treaties the United States has entered into with its trading partners. It could also invite retaliation by foreign countries against U.S. companies. TEI believes that the provision represents bad tax policy and could seriously harm the competitive ability of U.S. companies operating overseas. Accordingly, the Institute recommends that the proposal be rejected.

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[11] The proposal, which is based in part on a provision set forth last year in H.R. 5270 (102d Cong.), would statutorily modify Treas. Reg. § 1.863-3(b), which provides that taxpayers may apportion 50 percent of the income derived from the manufacture of products within the United States and their sale outside the United States on the basis of the location of assets held to produce income from the sale; the other 50 percent of the income is sourced based on the place of sale determined under the title-passage rule.

[12] These foreign sales subsidiaries, moreover, produce Subpart F income that is currently taxable.

[13] S. Rep. No. 99-313, 99th Cong., 2d Sess. 329 (1986).

[14] Current law accords taxpayers an election either to deduct foreign taxes or to claim a credit with respect to income (and income-related) taxes paid to foreign governments. The proposal would eliminate the election.

[15] *See* H.R. Rep. No. 65-767, 65th Cong., 2d Sess. 11 (1918).

Excise Tax on Purchases from Related Foreign Parties

A proposal under consideration by the Subcommittee would impose a five-percent excise tax on purchases of tangible personal property by a U.S. corporation from a related foreign party that fails to provide the IRS with tax information (as required by section 6038A of the Code). Based on the sketchy information available, however, the Institute has significant misgivings about the tax policy and administrative implications of the excise tax proposal.[16] Thus, we share the Administration's opposition to the proposal.

First, the proposal would violate the anti-discrimination clauses of U.S. tax treaties by taxing foreign corporations differently from domestic corporations.

Secondly, there has been no showing that the sanctions currently contained in section 6038A have proven inadequate to secure necessary information for the IRS. Indeed, while cast as an excise tax, the proposal would in reality impose a penalty, and its enactment would exacerbate a problem that Congress vowed to remedy when it enacted penalty reform in 1989: the willy-nilly "piling on" of penalties.

In addition, the proposal raises a whole raft of administrative questions. For example, who would be responsible for collecting the excise tax, the purchaser (U.S. corporation) or vendor (foreign related party)? Would returns be required or would the tax be assessed by the IRS? What "purchases" would be taxable under the proposal? What "tax information" would the corporation be required to provide to the IRS in order to be exempt from the excise tax? In respect of what purchases would the excise tax be imposed? For example, if the foreign related party is determined in 1995 not to have provided requisite tax information in respect of its 1993 return, on what purchases would the tax be imposed? Those in 1993? 1995? The period 1993 through 1995?

Given the lack of specificity concerning the proposal, TEI recommends that it be rejected.

Conclusion

Tax Executives Institute appreciates this opportunity to present our views. If you have any questions, please do not hesitate to call me at (708) 937-8523 or Timothy J. McCormally of the Institute's professional staff at (202) 638-5601.

Respectfully submitted,

TAX EXECUTIVES INSTITUTE, INC.

Ralph J Weiland

By: ______________________________
Ralph J. Weiland
International President

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[16] Press Release No. 10 states that the proposal would impose the excise tax on purchases *by* foreign corporations that fail to provide the IRS with tax information. The Joint Committee's description, however, refers to an excise tax on purchases by U.S. corporations *from* a related foreign party.

TESTIMONY OF TRUE COMPANIES

The True Companies appreciate this opportunity to offer their comments on various of the miscellaneous revenue issues and revenue raising proposals being considered by the Subcommittee on Select Revenue Measures. The True Companies are a group of family-owned businesses, most of them partnerships or S corporations, headquartered in Casper, Wyoming. The businesses are engaged in various aspects of the oil and gas industry, trucking, ranching and banking. The True Companies are deeply concerned with the impact of current tax laws, their complexity and the frequency with which they change on small and medium-sized businesses and the overall economy.

We know that Congress, Treasury and the Internal Revenue Service are all concerned about these impacts on American businesses. Nevertheless, it sometimes appears that this concern is lost in the search for relatively insignificant amounts of revenue. The effect is tax laws that are unreasonably burdensome for business and unadministerable for Treasury.

The True Companies therefore offer the following comments on certain proposals before the Subcommittee.

1. The use of 200 percent declining balance depreciation for automobiles for alternative minimum tax purposes.

The True Companies support the proposal to provide for the use of 200 percent declining balance depreciation for automobiles for alternative minimum tax purposes. Adoption of this proposal would simplify the AMT computations. Larger depreciation amounts in the earlier years would result in smaller deductions in later years. When fully implemented, this change would result in very little revenue loss. This minimal loss is more than offset by the value of simplifying the alternative minimum tax computation.

2. Requiring a portion of advertising expenses be capitalized and amortized over a period of years.

The True Companies recognize that businesses design advertising campaigns to accomplish specific objectives. We believe that, as a factual matter, in most cases advertising expenditures are designed to provide immediate, short-term benefits for the advertiser's business. Such campaigns provide little or no lasting value, and rarely any value that lasts beyond twelve months.

When long-term value is created, we believe that it typically represents a minimal portion of the total expenditures for the advertising campaign. It is therefore our position that capitalizing any portion of such advertising expenditures is inconsistent with current policy of allowing an immediate deduction for ordinary and necessary business expenses. Requiring a portion to be capitalized creates additional burdens and complicates accounting procedures for business taxpayers with little additional revenue. In fact, this proposal may reduce overall advertising spending, with adverse impacts on the overall economy and tax receipts.

3. Freezing the automobile standard rate at the 1993 level for 1994 and thereafter rounding the rate down.

It has been proposed that the standard mileage rate used to determine deductible automobile expenses incurred for the business use of such vehicles be frozen for taxable year 1994 at the 1993 rate. It has also been proposed that for 1994 and subsequent years the rate be rounded down to the nearest whole cent.

Transportation, like communication, is an essential part of doing business. Furthermore, automobile expenses continue to increase annually as other business expenses do. Thus this proposal is akin to allowing only a portion of a business's telephone costs or its wages and salaries. The True Companies believe that businesses, many of which must use automobiles, ought to be allowed to take the full cost of automobile use, as represented by the standard mileage rate, as a business deduction (as under current law). Anything less is simply a penalty for engaging in a trade or business.

We also believe that rounding the rate down provides neither meaningful simplification nor significant additional revenue. Some might suggest that this proposal indicates that its proponents have exhausted ways of "nickel and diming" the taxpayer and are now reduced to looking for fractions of a cent.

4. Limiting the business mileage deduction for trips beginning at the taxpayer's home to mileage in excess of 10 miles.

This proposal would reinstitute the use of auto logs for those whose business trips might begin at home. The True Companies believe that this proposal would produce so little revenue in comparison to the recordkeeping burden imposed upon such taxpayers that the proposal cannot be justified. If the Subcommittee feels that expenses associated with the use of automobiles by American businesses should not be deductible, it should simply amend Internal Revenue Code Section 162 to deny the deductibility of all such expenses.

5. Limiting business travel deductions to the amount of coach fare if coach passage is available for the trip.

The True Companies oppose the proposal to deny a business deduction for travel expenses in excess of the amount of coach fare if coach passage is available for the trip. The proposal fails to consider bona fide business reasons for not using a regularly-scheduled airline or booking a class other than coach.

The True Companies' operations are primarily in the Rocky Mountain Region. Other than Denver and Salt Lake City, most cities in the Rocky Mountains that have air service have very limited flights available. Traveling between small cities is especially inconvenient because of the "hub and spoke" system being used by United States carriers. Thus a business may save enough in meal and lodging costs by using a nonscheduled flight to more than offset the additional travel costs, especially when several employees are traveling together. Similarly, the use of a charter may allow an employee to travel to multiple locations in the same business day, which again may be more efficient and save meal and lodging costs. Even when an employee travels a regularly scheduled carrier, flying business class may allow the employee to conduct business with more privacy than could be conducted in coach class and arrive for business meetings after extended trips more refreshed and efficient.

We believe that determining the most efficient and cost-effective travel arrangements is an issue that should be left to individual businesses. Accordingly, the True Companies oppose this proposal.

6. Increasing the tariff on imported crude oil by 15 cents per barrel and refined petroleum products by 1 cent per gallon.

The True Companies have been gravely concerned about the continuing deterioration of the domestic oil and natural gas industry, a deterioration that we see as a growing threat to national security and economic stability. The alarming losses to the United States' capacity to produce adequate supplies of domestic oil are directly related to the growing level of cheap oil imports, which are expected to reach a record high this year of eight million barrels of oil per day, more than

50 percent of our daily requirements. Accordingly, the True Companies have long supported the imposition of tariffs on imported crude oil and imported refined petroleum products.

The proposal to increase the tariff on imported crude oil by 15 cents per barrel is simply inadequate, however, to have any measurable effect. Similarly, increasing the tariff on refined petroleum products by 1 cent per gallon is insignificant. If the deterioration in the domestic oil and gas industry is to be arrested and reversed, if the United States is ever again to have the capacity to produce adequate supplies of petroleum, the Congress of the United States must address the flood of cheap crude oil. This proposal does not begin to do that.

7. Increasing the heavy truck chassis tax from 12 percent to 12.1 percent.

The Revenue Reconciliation Act of 1993 raised the transportation fuels excise tax on diesel fuel and gasoline by 4.3 cents per gallon, effective October 1, 1993. This comes as another blow to an industry already hard hit by high tax burdens and narrowing profits.

The True Companies believe that increasing the heavy truck chassis tax on top of the increase in fuels excise tax is inappropriate, particularly in light of the condition of the industry.

8. Imposing a 30 percent excise tax on expenditures of tax-exempt organizations for lobbying.

Present law, if enforced, for all practical purposes severely curtails or eliminates lobbying activities. Taxpayers no longer have a voice in their government. Imposing an excise tax on tax-exempts is overkill, in our opinion.

9. Increasing estimated tax payments under the safe harbor method to 115 percent of last year's tax liability for individuals with adjusted gross income over $150,000.

This is but one of the proposals relating to prepayment of tax liabilities, either through withholding or estimated payments. We observe that all of these proposals appear to bear no relationship to an accurate prepayment of actual tax liabilities. Instead, they seem to focus on providing interest-free loans to the United States Treasury.

The Revenue Reconciliation Act of 1993 simplified the estimated payment rules for individuals with adjusted gross income of more than $150,000. Under the new rule, these individuals may pay 110% of the previous year's tax as a "safe harbor" estimated payment amount. This rule is effective for tax years beginning after December 31, 1993.

Because the new rule has not yet become effective, we question whether one can say whether it results in underpayment of estimated income tax liabilities. Instead, it appears to be simply another revenue raising measure at the expense of middle and upper-income taxpayers.

These kinds of proposals also raise revenue at the expense of voluntary compliance. The estimated tax rules have been changed repeatedly in recent years, with the provisions of the Revenue Reconciliation Act of 1993 being an attempt to simplify the rules and end the multitudinous changes. It makes no sense to tinker with the new rules at this point by changing 110% to 115%. Accordingly, the True Companies oppose this proposal.

10. Requiring written substantiation of any meal or entertainment business expense, or requiring substantiation of any such expense over $10.

This proposal is truly a nightmare for businesses that incur meals and entertainment expenses, as well as those that provide these services. Although the True Companies' entertainment expenses are limited, many of our employees must travel if we are to do business in the Rocky Mountain Region. Requiring that our companies keep a receipt or other substantiation for every meal reimbursement would create an enormous paperwork, recordkeeping and record retention burden.

The True Companies have their own policies requiring that their employees substantiate meal and entertainment expenses for reimbursement. The True Companies believe the present recordkeeping requirements are adequate for tax purposes. Accordingly, the True Companies oppose this proposal.

11. Denying corporations a deduction for all, or part, of interest paid to the IRS on tax underpayments.

Denying corporations a deduction for all, or part, of interest paid to the Internal Revenue Service on tax underpayments cannot be justified.

The True Companies believe that it is the government, not corporate shareholders, that ought to bear the burden of the Congress's constant tinkering with the tax laws--and the consequential inability of Treasury to keep up in the issuance of regulations and other guidance and business to keep up with whatever guidance is issued. The True Companies also reject the simple prejudice that businesses as such are more noncompliant taxpayers than anyone else.

At some point the Federal government must accept responsibility for the erosion in voluntary compliance among all taxpayers caused by constantly changing and incomprehensible tax laws and by tinkering with the laws to find uncertain amounts of revenue. This proposal shows that the government continues to look elsewhere for responsibility for this erosion in compliance.

12. Increasing the rate of interest payable on corporate tax delinquencies.

Denying a deduction for interest on corporate underpayments reflects an unwillingness to accept responsibility for the unfortunate state of the income tax system. This proposal reflects a willingness to profit by it.

13. Increasing the rate of withholding on bonuses from 28 percent to 36 percent.

Under current regulations, employers may elect to withhold at a flat 20% rate on bonuses and other supplemental wage payments that are not paid concurrently with wages. The Revenue Reconciliation Act of 1993 increased the withholding rate on supplemental wage payments from 20% to 28% effective for payments made after December 31, 1993. The House Committee Report states: "The committee believes that it is appropriate to raise the withholding rate on supplemental wage payments so that withholding more closely approximates the ultimate tax liability with respect to these payments." (H. Rept. p. 789.)

The True Companies believe that it is difficult to justify increasing the new withholding rate on bonuses by another 8% "so that withholding more closely approximates the ultimate tax liability with respect to" bonuses. If indeed withholding is intended to bear some relation to the ultimate tax liability, then proponents of this proposal must believe that bonuses are generally received by those in the 36% tax bracket: married taxpayers filing jointly with adjusted gross income over $140,000 and unmarried taxpayers with adjusted gross income over $115,000. Only a very small percentage of taxpayers are in this bracket.

The True Companies oppose this proposal because it is nothing more than requiring taxpayers in brackets less than 36%--most taxpayers--to make interest-free loans to the United States Treasury.

14. Disallowing deductions for compensatory damages under certain environmental laws.

The True Companies believe that this proposal is counterproductive and detrimental because it would have the effect of delaying prompt recognition and remediation of environmental noncompliance in an effort to delay or avoid incurring a nondeductible expense. The True Companies believe that most environmental hazards result from accident or ignorance. In today's climate of environmental consciousness and enforcement, no well-run business intentionally creates environmental hazards for which it might be liable. This proposal, however, might provide an incentive for a business not to address promptly an unintentionally-created environmental problem or a hazard created by another and discovered by the taxpayer.

The True Companies therefore oppose this proposal as bad public policy.

15. Amending Section 1031 to require that property received in an exchange be "similar or related in service or use" to the property exchanged, except for condemnations.

Internal Revenue Code Section 1031 generally allows for nonrecognition of gain or loss on the exchange of property solely for property of a "like kind," provided the property exchanged and the property received are "held for productive use in a trade or business or for investment." A considerable body of law has been created concerning what is "like kind" property and what it means for property to be "held for use in a trade or business or for investment." We note that creating this body of law has been costly for both taxpayers and the government. The rationale for Section 1031 is that a taxpayer should not be required to recognize gain or loss when an investment in business property or investments is merely transformed from one piece of property to another without the investment being "cashed out."

The True Companies believe firstly that the current limitations on nonrecognition treatment of exchanges--that the properties be of like kind and held for use in a trade or business or for investment--are appropriate and closely circumscribe nonrecognition treatment. These limitations are consistent with the purpose of Section 1031 but sufficiently flexible for most taxpayers' business and investment decisions.

Secondly, the True Companies believe that an additional limitation to the effect that the property be "similar or related in service or use" is neither appropriate nor sufficiently definite to avoid extensive litigation to develop the concept. The limitation is inappropriate because it excessively limits the availability of Section 1031 in legitimate business planning. The term "similar or related in service or use" is also ambiguous when applied to property held for use in a trade or business. It is extremely ambiguous when applied to various kinds of property that might be held for investment.

The True Companies are therefore opposed to this proposal.

16. Specifying the types of environmental remediation expenses that must be capitalized or requiring that all such costs be amortized over a uniform period of years.

The proposal to amortize all environmental remediation expenditures over a uniform period of years reflects a fundamental misunderstanding of the analytical framework for determining whether such costs should be capitalized or deducted currently. This analytical framework involves a determination as to whether the remediation expenses more closely resemble a repair or capital improvement. The repair-capital improvement distinction rests on the purpose of the income tax--i.e., to tax net income. To compute net income, the expenses of producing income must be properly matched against that income. The proposal to amortize all environmental remediation expenditures can be justified only on two grounds: as a pure revenue measure, or when the remediation expenditures are properly matched against a future income stream. In some cases, such as when remediation expenses are associated with the acquisition of property, the costs are capital in nature. In most cases, however, clean up costs are most properly matched against a past income stream, and thus should be currently deductible.

The proposal to identify types of remediation expenditures that must be capitalized is equally flawed. The type of expenditure generally has little to do with the income to which the expense is properly matched.

The True Companies oppose these proposals as analytically flawed and, like the proposal to disallow deductions of certain environmental remediation expenses, contrary to public policy. The determination as to whether these expenses should be capitalized or deducted currently should be made by applying the traditional legal tests.

Conclusion

The True Companies thank the Subcommittee for the opportunity to present these comments. While we regret being unable to be more positive toward some of these proposals, we believe some of them epitomize a trend in some tax legislation. That trend is to impose burdensome new requirements on business that are inconsistent with good tax and public policy, and with ease of administration, solely for uncertain additional revenues.

The Subcommittee's consideration of these remarks is genuinely appreciated.

TESTIMONY OF JOHN SODOLSKI
UNITED STATES TELEPHONE ASSOCIATION

The U.S. Telephone Association ("USTA"), the primary trade association of local telephone companies serving more than 99 percent of the access lines in the United States and representing over 1100 members ranging in size from the regional Bell companies to the smallest of independents, is pleased to present testimony on several of the revenue-raising proposals that were the subject of hearings before the Select Revenue Measures Subcommittee of the Committee on Ways and Means.

We understand that the underlying rationale for these hearings is to focus on proposals that could be adopted to offset long-deferred miscellaneous revenue-losing provisions that have been put forth by members of the Committee. In the course of finding the "pay for" items that will be necessary, we would urge that the Committee reject revenue-raising proposals that are not consistent with either sound tax policy or tax simplification. Further, we share the concerns of those who have commented that our tax system should not be beset by new provisions that in the short term provide revenue but for the future erode the internal discipline of well-established policy principles. On the other hand, USTA supports efforts to legislate sound tax policy and simplification within budgetary restraints and wishes to assist the process.

Set forth below are our comments on a number of the revenue-raising proposals under review by the Subcommittee.

Communications Excise Tax

As this Subcommittee knows, the United States Telephone Association has historically opposed, and continues to oppose, the three percent communications excise tax and any expansion of it. We have opposed the tax as an additional, unwarranted expense imposed on a fundamental aspect of modern daily life and an unnecessary burden on commerce. It is not only USTA that believes there is no sound policy rationale for the excise tax. The Treasury Department, in a 1987 study presented to Congress, recommended the excise tax be allowed to expire as there was, in its view, no policy rationale for its retention.

Absent total repeal of the three-percent communications excise tax, USTA would support efforts to ensure tax policy does not pick winners and losers in the telecommunications market.

A technological revolution is underway in communications. The result of this revolution is that what had been clearly discernable boundaries between telephone, broadcasting and cable services are now blurred. Technology today permits telephone calls to be completed over cable infrastructure and video programming to be transmitted over telephone wires.

This changing technology is altering the present competitive structure of the industry, and presenting imposing new challenges to tax policy. The Treasury Department, in its ongoing communications excise tax project, has an opportunity to explore the proper taxation of new competitive services. Should the Subcommittee determine not to repeal the current telecommunications excise tax, regulations can and should be clarified to insure a level playing field for taxation of defined "communications services" regardless of the services' provider.

For the reasons mentioned above, USTA also opposes repeal of the news services exemption.

Interest on Deficiencies

Currently, corporations that underpay their taxes due to a legitimate dispute with the IRS must pay the taxes owed plus interest for the period of the deficiency in an amount equal to the federal short-term interest rate plus three percent. If a subchapter C corporation's deficiency exceeds $100,000, the interest rate increases to the federal short-term interest rate plus five percent under the terms of the so-called "hot interest" provision of the Internal Revenue Code as enacted in 1990. In addition, corporations that substantially understate their taxes owed, disregard rules or regulations, or are negligent, must also pay a non-deductible penalty equal to 20 percent of the taxes owed (75 percent if the deficiency was the result of fraud). We believe these rules offer more than adequate incentives to ensure compliance.

USTA opposes proposals that flatly deny corporations a deduction for the interest paid to the IRS on tax underpayments or increase the rate of interest payable on such underpayments. It is no secret that our tax system has become enormously complex leading to frequent disputes between taxpayers and the government. In fact, for large corporations under constant audit, such disputes are an integral part of daily business. Disputes arise, more often than not, because of the complexity of transactions in a dynamic marketplace. The interest charged corporations while engaged in good faith disputes with the IRS over tax liability should be both fair and reasonable and should remain deductible as a legitimate business expense. To deny the deduction for interest on deficiencies, which is an ordinary and necessary business expense, effectively increases the corporate tax rate in a punitive manner.

Were underpayment interest costs to rise (either due to an increase in the statutory interest rate or revoking the deductibility of such interest expenses), so would the cost of going to the Tax Court, the preferred and specialized forum created by Congress for resolution of tax disputes. Since the Tax Court only has jurisdiction over cases in which the IRS claims the taxpayer has an unpaid liability (on which interest is charged), these proposals effectively would force taxpayers to pay the liability in order to avoid the punitive interest charges and bring suit for refund in the U.S. Court for Federal Claims or in U.S. District Court. As a result, the docket backlog in those courts would dramatically increase as cases are diverted from the Tax Court. In addition to these administrative and jurisdictional concerns, it is also unbalanced and harsh tax policy to provide an interest expense deduction to the corporate taxpayer who borrows money to pay taxes owed when they are due and sues for a refund, while the taxpayer who legitimately chooses to obtain Tax Court jurisdiction is denied a deduction while also being charged an above-market interest rate on the deficiency.

Environmental Remediation Costs

USTA fully supports efforts to clarify the tax and accounting treatment of environmental remediation costs, but opposes the alternative proposal to require that all environmental remediation costs be capitalized and amortized over a uniform period. Uncertainty over whether to expense or capitalize costs associated with environmental clean-ups is resulting in significant confusion in corporate planning, tax, and finance. Because these clean-up costs usually do not lead to any financial benefit to the company forced to incur them, and because companies often are required by Federal or state law to incur such costs, USTA strongly believes that these costs should be deductible as they are incurred and should not have to be capitalized.

Like-kind Exchanges

USTA opposes the proposal to amend the like-kind exchange rules of Code section 1031 to require that property received must be "similar or related in service or use" to the property exchanged except in the case of condemnations. Telephone companies trade FCC-approved cellular licenses, real estate, operating areas, and other assets for other like-kind assets. By limiting the ability of companies to complete such exchanges this proposal would prevent assets from being put to their highest value use and would inhibit productivity. Only when a company actually realizes gain by selling assets should a tax be imposed. In accord with President Clinton's call for increased investment in American productive assets, section 1031 appropriately encourages reinvestment rather than liquidation. This proposal, in an active and dynamic marketplace, will discourage this needed reinvestment.

Advertising Expenses

USTA wishes to join the chorus of opposition to the proposal to capitalize a portion of advertising expenses. If adopted, this proposal would not only increase the cost of advertising undertaken by USTA member companies, but also could reduce revenues earned from the sale of advertisements in telephone directories.

Numerous studies, some of which have been cited by witnesses appearing before the Subcommittee, have found that expenditures for advertising do not lead to significantly increased sales beyond one year, and therefore should not be capitalized. This is particularly true for advertisements placed in telephone directories published by USTA member companies, which are replaced every year.

This proposal threatens to reduce business competition and force businesses to adopt less efficient but currently deductible methods of promoting their products. Some advertising expenditures would be eliminated, leading to less information for consumers and a less efficient marketplace. Furthermore, the proposal would put U.S. companies at a disadvantage with foreign competitors. Our view is that whatever tax revenue might be raised in the short term by capitalizing advertising expenses would be more than offset by increased costs to consumers and businesses as well as the related negative impact on the economy. For these reasons we oppose this proposal.

Compliance Issues

In light of the Clinton Administration's recently introduced plan to simplify government regulations and end wasteful practices, the proposals described below are a substantial step in the wrong direction. Not only do they unnecessarily add to record-keeping tasks and accounting costs for business, they will also burden IRS Revenue Agents with additional paperwork. The result would be a substantial waste of taxpayer and IRS resources with no significant additional tax revenue or other justification for the change.

♦ Withholding on Bonuses

USTA also opposes the proposal to increase the rate of withholding on bonuses from 28 to 36 percent. In a healthy attempt to link employee compensation to productivity, many businesses, including USTA member companies, pay bonuses to their employees. These bonuses are often paid to middle- or low-salary employees who are not subject to the maximum 36-percent rate. Such bonuses are frequently paid early in the year since they are usually based on the company's performance in the prior year. Because the IRS does not pay interest on excess withholdings, instituting a 36-percent withholding rate on bonuses effectively provides the U.S. government with an interest-free loan until a refund is obtained. Although Treasury Regulations provide an alternative to the flat withholding rate, calculating withholding under the alternative is not only burdensome on employers, but may still subject low- and middle-income employees who receive bonuses to excessive withholdings. In an era of increasing international competition, it seems ironic that the most innovative U.S. companies and their most productive employees would be those penalized.

♦ Meals and Entertainment

USTA opposes the proposal to require written substantiation of any meal or entertainment expense claimed as a business deduction and the alternative proposal to require written substantiation of any such expense in excess of $10.00. The current law de minimis threshold for written documentation of $25.00, even with inflation at relatively low levels, should be increased for administrative ease in the future -- not reduced or eliminated. In light of the recent reduction in the deductible percentage from 80% to 50% for such expenditures we also think this proposal amounts to legislative "overkill".

- **Travel Expenses**

The proposal to deny a business deduction for travel expenses in excess of the amount of coach class fare if coach passage is available is similarly flawed. The compliance burden created by this proposal would only serve to increase administrative and accounting costs for both taxpayers and the IRS to such an extent that it may lead to a net revenue loss. Both businesses and the IRS would be required to monitor the price of first class and coach class tickets and the availability of coach class seats on every flight taken. As any traveller knows, ticket pricing and seat availability are subject to constant change between the time a ticket is purchased and the departure of any given flight. Consistent with the Clinton Administration's goal of streamlining government, the Subcommittee should reject this proposed additional layer of unnecessary complexity to the tax code.

Treatment of Certain Lobbying Expenses

USTA opposes the proposal to impose a 30-percent excise tax on lobbying expenditures by certain tax-exempt organizations. Just last month President Clinton signed the Omnibus Budget Reconciliation Act of 1993 which denies a deduction for lobbying expenses and thereby denies a deduction for membership dues paid to tax-exempt organizations or associations to the extent the dues are used for lobbying purposes unless such organization or association pays a "safe-harbor" 35-percent proxy tax on its lobbying expenditures. Although this new proposal appears to be designed to primarily impact tax-exempt charities under section 501(c)(3) of the Code, it also apparently applies to all tax-exempt organizations (including 501(c)(6) trade associations) that do not elect to use the proxy tax safe harbor as provided under current law. As a result, under this new proposal such non-section 501(c)(3) tax-exempt organizations effectively would be denied the current law option of reporting their lobbying expenses to their dues-paying members rather than paying the 35-percent proxy tax.

The imposition of an excise tax on, or the denial of a deduction for, lobbying expenditures impedes the ability of citizens, industries, and special interest groups to be heard in the legislative process. Imposing an excise tax on the constitutionally protected right of citizens to petition their government violates the democratic principles of this country. USTA represents hundreds of companies in an industry that is a fundamental part of modern daily American life. This proposed excise tax interferes with the ability of our industry, and all others, to have their government respond to their articulated needs and concerns, and should be soundly rejected by the Subcommittee.

Foreign Tax Credit

The proposal to change the foreign tax credit to a deduction is particularly distressing to USTA. Congress enacted the foreign tax credit in 1918 to prevent U.S. taxpayers from being taxed twice on their foreign source income -- once by the foreign country where the income is earned, and again by the United States. If the foreign tax credit were a deduction, American telephone companies would be forced to pay higher taxes than their foreign competitors on foreign source income, thereby placing U.S. telephone companies at a worldwide competitive disadvantage. When a USTA member company competes abroad, its foreign competitors are allowed foreign tax credits by their home governments, are exempted from tax on foreign income by their home country, or are themselves domestic companies that by definition are only subject to the taxes in that country.

Although changing the foreign tax credit to a deduction may raise tax revenue in the short term, the cost to the U.S. Treasury and to the U.S. economy as a whole will far outweigh any short-term revenue benefits. The foreign operations of USTA companies serve as a vital source of U.S. exports and provide thousands of jobs here in the United States. Further, the U.S. collects taxes on the repatriated foreign source income of USTA companies to the extent that the U.S. tax liability exceeds the foreign taxes paid.

Because foreign tax credits can only be used to offset U.S. income taxes owed on foreign source income and do not reduce U.S. taxes owed on profits generated by U.S. operations, this proposal will harm only those companies that have been successful in the international marketplace. USTA represents an industry that has been one of America's most successful overseas. In fact, we are the world leader in the technology and design of communications systems. While the foreign tax credit regime is far from perfect, its elimination would place us at an even greater competitive disadvantage and would be clearly at odds with sound multi-national tax policies.

This proposal is not only objectionable on broad economic and tax policy grounds, it is also flawed in its specifics. The proposal would deny the credit retroactively for foreign taxes paid prior to the date of enactment where certain "deemed paid" rules apply to pre-effective date years. Amending the tax laws retroactively makes it virtually impossible for U.S. business to properly plan and invest for the future, and undermines confidence in our tax system. The proposal also would override U.S. tax treaties requiring that U.S. taxpayers receive foreign tax credits for certain taxes imposed by the respective treaty partners. Abrogation of our tax treaty obligations could not only result in renegotiation of such treaties but, more importantly, would cripple U.S. credibility in negotiating these and other tax treaties in the future.

STATEMENT FOR THE RECORD BY REP. BARBARA F. VUCANOVICH
SUBCOMMITTEE ON SELECT REVENUE MEASURES
HOUSE WAYS & MEANS COMMITTEE
SEPTEMBER 21, 1993

Mr. Chairman, I wish to make known my opposition to several proposed revenue raising measures pending before your Subcommittee.

Specifically, I am opposed to :

-- Reducing the tax deduction for gambling losses from 100 percent to 80 percent.

-- Increasing the federal excise tax on wagers from one-quarter percent to one percent.

-- Increasing the rate of tax withholding on certain gaming winnings from 28 percent to 36 percent.

Recently Congress passed the Budget Reconciliation Bill despite my opposition. Due to revenue shortfalls Congress must now consider different ways to raise revenue. Your Subcommittee is now considering the above three proposals to raise gaming taxes which it is estimated could generate roughly $120 million in additional revenues.

I am concerned that the Subcommittee is singling out the gaming industry and that, because of the success of the gaming industry, Congress will turn to the gaming industry every time a quick revenue fix is needed. Gaming is the pre-eminent industry in my State of Nevada. In other states gaming makes up only a portion of the economy. Therefore, any such tax proposals would have a disproportionate affect on the State of Nevada.

I believe that the gaming industry has already been asked to do its fair share for deficit reduction. As part of the reconciliation bill

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they will pay higher corporate taxes and will suffer because of higher fuel taxes and the reduction in the deduction for business travel, meals and entertainment expenses.

The gas tax will hit Nevada hard. It will cost the typical Nevada motorist 80 percent more than a New Yorker. Nevada drivers will be paying a total of 42.4 cents per gallon in state and federal taxes at the gas pump. This gas tax will also have a negative impact on tourism in our State.

The service industry employs more than 210,000 in Nevada yet under this plan the State will lose over 4,500 jobs because of the change in the deductibility of business entertainment expenses.

Mr. Chairman, my State simply cannot afford any more revenue losses. These proposed tax increases pending before your Subcommittee simply are not fair and I urge you to reject them.

Thank you.

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